



IMPROVING GLOBAL FINANCIAL STABILITY

A Policy Statement by the Research and Policy Committee of the Committee for Economic Development

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RESPONSIBILITY FOR CED STATEMENTS ON NATIONAL POLICY

The Committee for Economic Development is an independent research and policy organization of some 250 business leaders and educators. CED is nonprofit, nonpartisan, and nonpolitical. Its purpose is to propose policies that bring about steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all.

All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This committee is directed under the bylaws, which emphasize that “all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group.” The committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pend-

ing specific legislative proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication.

The recommendations presented herein are those of the trustee members of the Research and Policy Committee and the responsible subcommittee. They are not necessarily endorsed by other trustees or by non-trustee subcommittee members, advisors, contributors, staff members, or others associated with CED.

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PURPOSE OF THIS STATEMENT

In the wake of the Asian, Russian, and Brazilian financial crises in 1997–98, a wide range of proposals were made to reconstruct the “international financial architecture.” Some called for radical change and wholesale redesign of existing institutions. As business leaders, we take a more pragmatic approach. In this statement we recommend incremental changes that rely heavily on the power of markets to improve the functioning of those institutions and the international financial system.

We firmly believe that the globalization of financial markets holds the promise of higher incomes and improved social standards worldwide. We realize, however, that this promise may go unfulfilled if the international financial system is unstable. The challenge for policy makers is to put the system on a more stable footing.

As this statement was being developed, two new policy studies were released that addressed similar issues—*Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture* (by a task force of the Council on Foreign Relations) and the congressionally-mandated report of the International Financial Institutions Advisory Commission. Our policy statement shares many common features with these reports. We agree that recent financial crises have had multiple causes and that many financial problems in developing economies have been home grown. However, our recommendations differ in important respects. We are concerned about the potential reduction of capital available to developing countries from proposals to mandate collective action clauses in bond contracts and “bailing in” investors. We also believe that the International Monetary Fund has played an indispensable role in crisis prevention and restoration of stability when crises occur. Changes at the IMF are clearly needed, but our recommendations would build incrementally on the

IMF’s successes rather than radically revise its mandate and procedures.

CED has issued many policy statements on international economic issues, including most recently *U.S. Economic Policy Towards the Asia-Pacific Region* (1997). Since its active role in creating the Bretton Woods institutions in the 1940s, CED has consistently supported open markets and institutions and strategies that recognize, facilitate, and manage growing interdependence within a global economy. In addition to this study of the international financial system, CED expects to undertake an analysis of America’s relationship to the international trading system. Together, these studies should help show the way to a more robust global economy, reduced conflict, and higher living standards worldwide.

ACKNOWLEDGMENTS

This policy statement was developed by the committed and knowledgeable group of business, academic, and policy leaders listed on page vii. We are grateful for the time and effort they dedicated to make this report balanced and comprehensive.

Special thanks go to the subcommittee co-chairs, George F. Russell, Jr., Chairman of the Frank Russell Company, and Kathleen B. Cooper, Chief Economist and Manager, Economics & Energy Division, Exxon Mobil Corporation, for their leadership, enthusiasm, and guidance. We are grateful to project director Elliot Schwartz, Vice President and Director of Economic Studies at CED and Van Doorn Ooms, CED’s Senior Vice President and Director of Research, for their contributions, and to Helena Zyblikewycz for research assistance.

Josh S. Weston, *Chairman*
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CHAPTER 1

ADJUSTING TO THE NEW REALITIES OF THE INTERNATIONAL FINANCIAL SYSTEM: FINDINGS AND RECOMMENDATIONS



The international financial system normally provides large economic benefits, but localized breakdowns in that system—financial crises—have occurred frequently over the past two decades. Although officials in affected countries and international financial institutions have responded reasonably well to recent crises, the costs of those crises have been significant. The direct costs of unemployment, poverty, and bankruptcies experienced in the crisis countries are obvious. The slowdown in growth of output and income in other countries, although less obvious, also has been costly. Even greater costs will be incurred if international trade and investment, which have underpinned advances in global prosperity, are curtailed because of a continual threat of disruption of financial markets and losses by investors.

Since the Mexican crisis of 1994/95, public and private observers have been learning from these crises and proposing reforms of the international financial system. While we agree that reform is needed, we believe the system is fundamentally sound. Despite initial fears prompted by the financial crises that rolled through Asia, Russia, and Brazil, the global financial system did not suffer catastrophic failure, and most crisis countries have recovered. The relatively fast recovery and mildness of spillover to other countries as a result of the Asian crisis has placed the burden of proof on those who would radically restructure the international financial system. Rather than redesigning the international financial architecture, reformers should be focusing on how individual

countries can improve and upgrade their domestic institutions and policies to foster sustained economic growth.

Proposed reforms would have serious implications for world and regional economic growth and for the prospects of internationally oriented businesses. To date, however, debate regarding these reforms has had limited input from the business community, despite the dramatic impact that these crises have had on business around the world. U.S.-based businesses invest, lend, and trade at substantial levels with the developing countries most involved in recent crises. In 1998, the stock of U.S. foreign direct investments (FDI) in developing countries was valued at approximately \$300 billion, and the net annual FDI outflow from the U.S. to developing countries was about \$27 billion.¹ U.S. bank lending to these nations amounted to about \$95 billion,² while U.S. exports to and imports from them were \$306 billion and \$421 billion respectively.³

ADAPTING TO THE NEW REALITIES OF INTERNATIONAL FINANCE

Paradoxically, the problems of the past few years are a result of the very successes of the post-World War II global economic structure

1. *Survey of Current Business*, November 1999, Table G-2.

2. Bank of International Settlements, *Consolidated International Banking Statistics*, November 1999, Table 2.

3. Trade figures are for 1997. IMF, *Direction of Trade Statistics Yearbook*, 1998, p. 456.

and transformative changes in information technologies. Extensive global economic integration and high-speed transmission of information, economic decisions, and money are major features of today's financial system. The size and structure of the global economy and, in particular, the role of financial capital have changed significantly in the 50 years since the establishment of the International Monetary Fund (IMF) and the World Bank. One central feature has been the emergence of new capital markets, especially in Latin America and Asia, where many developing countries have experienced substantial and sustained improvements

in real per capita income. Those improvements have come, in part, because of the trade and investment linkages those countries formed with more developed economies. As a result of policy reforms undertaken by emerging market countries that have made them more attractive to foreign investors, private capital flows to those countries now vastly outweigh official capital transfers. An important feature of the new economic landscape is the enormous volume of transactions in financial assets, which now may be more important than trade to a nation's economic growth and stability.

FINDINGS

After examining recent financial crises, we conclude that the international financial system suffers because institutions and policies have not adjusted sufficiently to changes in markets and technologies that have altered the economic landscape. In particular, the development of the institutional and social infrastructure in many developing countries significantly lags the development of commercial and financial business. Our major findings are:

- In general, the international financial system works well and generates widespread benefits. It enhances global economic growth and efficiency by performing essentially the same functions as domestic financial institutions. It facilitates trade in goods and services and links the supply of savings to the demand for capital. It provides a stable source of foreign capital to developing countries and a vehicle for transfer of technology and managerial know-how via foreign direct investment.
- These benefits of the international financial system, however, have been accompanied by significant economic costs resulting from periodic crises. The stability and reliability of the system can be improved by strengthening its basic foundation. This

foundation rests on a market-based international economic system, domestic political and economic institutions that promote market efficiency, integrity, and economic growth, and international financial institutions, such as the IMF, World Bank, and Bank for International Settlements.

- It is essential that governments, private-sector businesses, and international financial institutions learn from recent experiences and make the adaptations necessary to avoid or minimize the costs of future financial crises. However, the wholesale redesign of what has been termed "the international financial architecture" would be a mistake. Reforms should build upon and enhance the existing architecture, rather than raze it and create new structures.
- Problems in crisis countries for the most part have been home grown. Countries with inadequate economic, social, and legal infrastructures and poor government policies are susceptible to financial crises and capital flight. Sound government institutions and policies that support social and economic goals are necessary to any well-functioning market economy.
- No matter how good preventive efforts are, financial crises are likely to occur. When

they do, a strong international backstop—namely, the International Monetary Fund—is needed to restore confidence and stabilize the system. A strong IMF is indispensable to the continued stability and vitality of the international financial system. We should commend the IMF and work to improve it, rather than condemn it.

- The financial costs of stabilization lending have grown substantially. Under current policies and structures, the IMF will not always have sufficient funds to cover the demand for stabilization lending.
- Mandated private-sector bail-ins would damage the longer-term goal of transferring capital to emerging markets. Market forces already impose significant costs on foreign private investors and lenders who take excessive risks. If public officials establish rules to impose additional costs, they will prolong and deepen those crises that do occur because private-sector capital will be withdrawn just when it is most needed—as crisis approaches.

RECOMMENDATIONS FOR ACTION

Our recommendations outline the steps that should be taken by developing and developed country governments, business and political leaders in the United States, and the International Monetary Fund. These recommendations are founded on our conviction that the system can best be improved by continuous incremental reforms that build on market principles. We note that, as this project neared completion, the U.S. Administration put forward a set of proposals that are very similar to our recommendations.⁴ We commend the Administration for taking the lead in promoting appropriate reforms and urge it to pursue those reforms vigorously.

Developing Country Governments

Developing countries should increase efforts to improve the fundamental institutions and policies that support market-based economies open to international investment. Such efforts should seek to develop or maintain government institutions that root out corruption, provide an independent and honest judicial system, and enforce the collection of taxes; follow sound macroeconomic policies; protect

property rights; rely on markets; adopt even-handed and transparent regulation where necessary to correct well-identified market failures; and provide open and transparent access to information.

CED encourages developing countries to adopt and apply international codes of conduct based on established and transparent standards and best practices to help build and improve their economic and political institutions. We support on-going efforts to codify such standards and the greater use of private-sector resources, including for-profit enterprises, volunteers, and paid technical experts, to help developing countries raise their standards of practice. Countries that adopt international standards of best practice and improve domestic policies will attract the foreign private capital necessary for long-term economic growth. We recommend that the following actions be taken by governments in the specific areas of accounting standards, banking regulation, bankruptcy procedures, corporate governance, and social policy.

- They should increase the transparency and accountability of both government and private institutions.
- They should strengthen bank supervision and remove impediments to the operation

4. Lawrence Summers, "The Right Kind of IMF for a Stable Global Financial System" Remarks at the London Business School, London, England, December 14, 1999.

of foreign banks in competition with domestic institutions. Governments should refrain from providing explicit or implicit guarantees of private investments and from using the banking system to guide investments.

- They should establish bankruptcy procedures that are transparent and even-handed. These procedures should allow the claims of creditors to be discharged fairly and provide the basis for the reemployment of productive assets and the continuation of viable enterprises. Domestic and international creditors of an insolvent or bankrupt institution should receive equal and fair treatment in any workout or debt restructuring.
- They should establish clear and viable rules to define the agency relationship between managers and shareholders and protect the rights of shareholders. The rights of minority shareholders of corporations that are predominantly family-owned or part of a larger cross-ownership group should be protected.
- They should establish more comprehensive social safety nets to better protect and assist vulnerable groups in time of crisis or significant economic transition.

In addition to those basic reforms, CED recommends that developing country governments make greater use of market-based solutions to resolve the difficult policy choices they confront. Specifically:

- CED believes that floating exchange rates are generally desirable for emerging market economies that participate substantially in international capital markets.
- Whatever exchange regimes countries choose, they should build sufficient international reserves to weather crises and should seek to establish lines of credit with private lenders that can be called upon in case of emergency.

- Emerging market countries should strengthen their domestic financial systems and work toward the goal of open capital markets. However, a temporary tax on short-term capital inflows may help a country with a weak financial system to avoid economic damage associated with the volatility of short-term capital while it is engaged in reform.

U.S. and other Developed Country Governments

Since developed countries are the primary sources of financial capital going to emerging markets, governments in those countries should remain committed to an open global financial system and in particular to the global institutions, such as the IMF, that support that system. Developed country governments should:

- create standards that would provide better public information about the financial condition of highly leveraged financial institutions;
- leave the decision of whether to use collective action clauses in international bond contracts to market participants, rather than mandating their inclusion;
- ensure adequate funding for the IMF and support improvements in its policies and operations.

Developed country governments should also recognize that the world's heavily indebted poorest countries (as defined by the Heavily Indebted Poor Countries Initiative) lack both the resources and incentive to adopt better policies while burdened by debt that they cannot repay. CED urges developed country governments to grant relief from official debt and provide other forms of financial and technical assistance for very poor countries that are trying to establish a foundation for economic growth through improved domestic policies.

Business Leaders in the United States

The primary task for business leaders in the United States is to support the government's

commitment to an open global financial system and encourage reforms that will make the system stronger and more stable.

Specifically, business leaders should:

- support the efforts of developing countries that are making necessary economic and social improvements, through direct investments, loans and other lines of credit, and technical assistance for raising standards of practice;
- support the IMF and other institutions of the international financial system;
- resist radical change of the system, such as elimination of the IMF or creation of new global economic regulators, since these radical proposals are either risky or unworkable;
- foster the understanding that businesses cannot and should not rely on local government or IMF bailouts to insure against losses on investments or loans.

International Financial Institutions

The international financial institutions face many challenges. Our recommendations focus on the IMF because of the important roles it plays in helping countries to prevent crises and in providing or restoring stability when there are financial crises.

- The IMF should continue to learn from recent experience and adapt to the new realities of the international financial system. The IMF is to be commended for re-evaluating its own policies; however, it should go further and faster than it has to date.
- The IMF should continue to improve its operating procedures by becoming more

transparent and accountable with regard to its own decision-making and by providing better and more frequent information to the public.

- The IMF should go beyond its current policy of *encouraging* member countries to release publicly information developed in the course of Article IV consultations, and *require* that such information be released within 60 days after the consultations take place. This policy change should be phased in over a reasonable period, perhaps one to two years.
- The IMF should take greater responsibility for identifying, monitoring, and investigating how IMF funds are spent and for ensuring that such funds are not siphoned off in fraud and corruption.
- The IMF should cease support where fraud and corruption in a nation that is receiving financial support from the IMF impedes the sound functioning of political, legal, and judicial systems.
- The IMF should emphasize sound macroeconomic policies and improvement of banking and financial systems in its lending advice.
- The IMF should place more emphasis on crisis prevention and less on stabilization programs. It should maintain normal lending limits and a policy of “constructive ambiguity” with regard to specific cases to diminish concerns about moral hazard. The IMF should have adequate—though not abundant—resources to promote both crisis prevention and stabilization.
- The IMF should act as a neutral “crisis manager” when the need arises—neither bailing in nor bailing out foreign lenders.

CHAPTER 2

LONG-TERM CHANGE IN THE INTERNATIONAL FINANCIAL SYSTEM



International capital markets have expanded rapidly in the past decade because of advances in technology, reforms of economic and political institutions in developing countries, and growth in trade and income fostered by international institutions and multinational businesses. Transactions in financial assets now have a substantial influence on a nation's economic growth and stability. The frequency and costliness of financial crises and the tendency of such crises to spread from one country to another threaten to curtail growth and improvements in incomes in poor countries.

CHANGE IN WORLD CAPITAL MARKETS SINCE THE END OF WORLD WAR II

Today's economy is defined by globalization—the integration of capital, technology, information, and production across national borders.⁵ Technological advances have been a major source of this integration. They have significantly lowered the costs of communication, transportation, and information processing, which has made it possible for businesses to diversify production, enter new markets, and create new products and services for sale throughout the world. Technology has also revolutionized finance, making possible the growth and diversity of financial instruments that support the growth of the real economy.

5. Thomas Friedman, *The Lexus and the Olive Tree*, (New York: Farrar, Straus and Giroux, 1999).

Overall, the growth of mutual funds, hedge funds, and derivatives, which allow for the unbundling and reconfiguration of risk, have raised the supply and lowered the cost of capital.

Another major factor in globalization has been the spread of free-market capitalism throughout the developing countries, especially since the fall of the Soviet Union. Although the most successful emerging market economies in Asia and Latin America have followed market-based economic policies for a long time, the spread of those policies and democratic institutions accelerated in the 1990s. Many governments reduced regulation and opened capital markets, which led to increased foreign direct investment and other private capital inflows.

Post-war economic policies under the Bretton Woods system also have played a major role in the creation of today's highly integrated global economy. Those policies fostered full employment and economic growth through a threefold strategy: first, to provide a stable economic environment, initially through a system of fixed exchange rates; second, to facilitate the expansion of trade based on comparative advantage; and third, to facilitate the transfer of capital from countries with relatively abundant capital to those short of capital but with large investment opportunities, initially in Europe and later throughout the developing world.

As restrictions on international trade and finance have fallen and countries have com-

mitted themselves to market-based economic systems, global trade and investment have grown dramatically. The volume of world trade has risen steadily over the past 50 years, tying the world economy closer together and generating growth in income and employment. The rise in international investment was most dramatic between the mid 1980s and the onset of the Asian financial crisis in 1997. The volume of foreign direct investment worldwide rose from a level of \$76 billion in gross flows in 1985 to about \$450 billion in 1997.⁶ Net foreign direct investment to developing countries increased from about \$18 billion in 1990 to \$138 billion in 1997. Net private capital flows of all types to developing countries rose during the same period from \$31 billion to over \$170 billion.⁷

The volume of transactions in foreign currency, now estimated to be about \$1.5 trillion *each day*, suggests the enormous scale of the global financial system.⁸ That daily figure is about one-fifth the *annual* value of world exports. Thus, a significant feature of today's global financial system is the apparent delinking of financial transactions from the underlying real economy. Where financial transactions once primarily financed the purchase of goods, services (such as travel), and investment in physical assets, they now often are far removed from those real activities; as little as five percent of daily currency transactions may be linked to trade in goods and services.⁹

Globalization has had a profound impact on the U.S. economy. U.S. participation in world capital markets—calculated as the sum of U.S. bonds and equities sold to foreigners and purchased from foreigners by Americans—equaled 4 percent of U.S. GDP in 1975 and 213

percent in 1997.¹⁰ Total cross-border sales and purchases of U.S. Treasury bonds rose from \$30 billion to \$500 billion between 1983 and 1993.¹¹ In trade, the sum of U.S. exports and imports rose from the equivalent of 17 percent of GDP in 1985 to 25 percent of GDP in 1997.¹² This international investment and trade has raised incomes in the United States and contributed to the creation of today's high productivity, low inflation economy.

The Importance of Capital Formation and Strong Institutions for Economic Development

Although many different factors play a role in economic development, a key component is capital formation, in part because capital investment embodies newer technologies. Investment is necessary for economic growth; countries that have grown most rapidly over long periods have devoted a high percentage of GDP to investment in physical and human capital. Studies of growth in East Asia in particular highlight the overwhelming importance of physical investment in that region.¹³ As shown in Table 1, page 8, both domestic savings and investment have been remarkably high in the East Asia and Pacific region.

A high level of capital formation, however, is not enough. Investments can be wasted on unproductive projects or concentrated in projects with few linkages to the overall economy. Many different elements must come together for growth to be sustained and transformative. The most successful developing countries have growth-oriented, market-based policies that are open to foreign investment. Macroeconomic stability has also been important for sustaining long-term growth and, in

6. International Monetary Fund (IMF), *International Capital Markets*, September 1998, p. 187.

7. IMF, *International Capital Markets*, September 1998, p. 13.

8. Council of Economic Advisers, *Economic Report of the President*, 1999, p. 224.

9. Barry M. Hager, *Limiting Risks and Sharing Losses in the Globalized Capital Market*, (Washington, DC: Woodrow Wilson Center Press, 1998), p. 6.

10. Bank of International Settlements, *Annual Report*, 1998.

11. John Eatwell, *International Financial Liberalization: The Impact on World Development*, UNDP Office of Development Studies, Discussion Paper #12, p. 4.

12. Economic Report of the President, 1999, Table B-1.

13. Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work*, Policy Essay no. 24 (Overseas Development Council, 1999) pp. 15-16.

TABLE 1
**Saving and Investment Rates
by Developing Country Region**

	Gross Domestic Investment (percent of GDP)		Gross Domestic Saving (percent of GDP)	
	1980	1997	1980	1997
Low Income	20	22	15	17
Middle Income	27	26	27	26
High Income	25	21	24	22
World	25	22	24	23
East Asia and Pacific	32	36	33	38
Latin Am. and Caribbean	24	22	22	20
Middle East and N. Africa	27	24	38	25
South Asia	21	23	15	18
Sub Saharan Africa	24	18	26	17

Definitions of country groups: Low-income, GNP per capita below \$785 in 1997; Middle-income, GNP per capita between \$785 and \$9,656; High-income, GNP per capita above \$9,656.

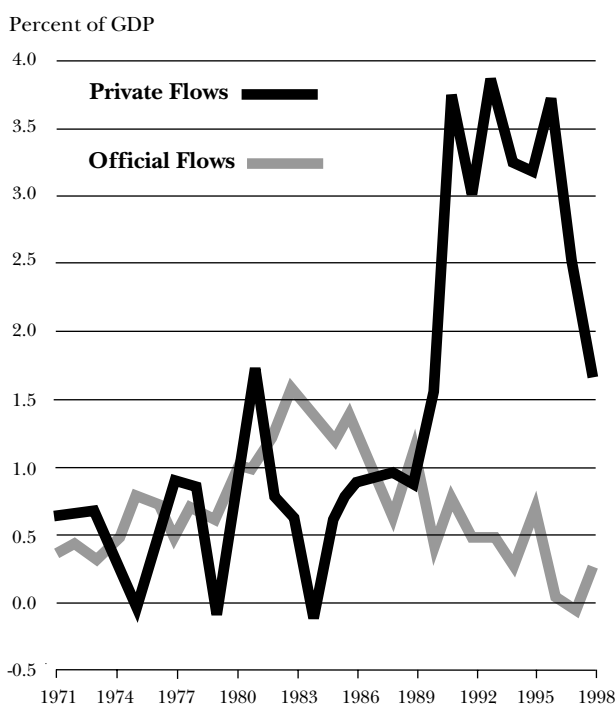
SOURCE: World Bank, World Development Indicators, 1999, Table 4.9

particular, for adjusting to changing circumstances and external shocks.¹⁴ Such adjustment is enhanced by markets that transmit economic information quickly and accurately and by effective social infrastructure—such as political participation, civil and political liberties, labor unions, non-corrupt bureaucracies, independent judiciaries, and social insurance programs—that allow competing interests to mediate their conflicts.

Even with high rates of domestic saving, many developing countries still need to import capital because they have more productive investment opportunities than they can finance.

14. Rodrik, *The New Global Economy and Developing Countries: Making Openness Work*, p. 99.

Some countries lack institutions that efficiently mobilize savings and channel resources to projects with high rates of return. Until recently, developing countries as a group were dependent on official sources for external capital. Figure 1 shows the trend of net private and official capital flows to developing countries from 1971 to 1998. Between 1971 and 1989, official and private capital flows each rose from near 0.5 percent of the aggregate GDP of developing countries to about 1 percent. Private flows fluctuated sharply during the period, falling three times to near zero and rising once to over 1.5 percent of GDP. Those patterns changed after many of the economically advanced developing countries began to open

Figure 1
Developing Countries: Private and Official Flows, 1971–1998


SOURCE: Michael Mussa, Alexander Swoboda, Jeromin Zettelmeyer, and Olivier Jeanne, "Moderating Fluctuations in Capital Flows to Emerging Market Economies," prepared for the Conference on Key Issues in Reform of the International Monetary and Financial System, IMF, May 28–29, 1999.

their capital markets in the early 1990s. Between 1991 and 1996, private capital flows were generally between 3.0 and 3.5 percent of the developing countries' aggregate GDP, while official flows trended toward zero. In 1997 and 1998, private flows fell and official flows rose because of the Asian financial crisis.

Private capital flows take many different forms. Foreign direct investment (FDI) accounted for about one-half of net private capital flows to emerging markets between 1992 and 1997.¹⁵ FDI usually refers to investment carried out by foreign private companies that play an active role in the management of a domestic enterprise.¹⁶ It reflects the investor's goal to obtain a lasting interest in an enterprise that resides in another country and implies a long-term relationship between the investor and the enterprise.¹⁷ In addition to the direct transfer of capital, economic spillovers from FDI, such as transfers of managerial and technological expertise, provide significant benefits to the host country. FDI brings both incomes and jobs to a country and adds to the government's tax base, which allows for more expenditure on social programs such as education, health, and sanitation.

Foreign direct investment fluctuates less than other forms of capital transfer. As shown in Table 2, during the recent financial crisis in Asia, FDI (direct equity, net) remained high for the five crisis countries and is even estimated to have increased into the recovery. Portfolio investment, which includes equity securities, debt securities in the form of bonds,

TABLE 2

	Asia 5*: Capital Flows (\$ billions)				
	1995	1996	1997	1998 ^e	1999 ^f
External Capital Flows, net	83.1	99.0	28.6	-4.2	7.8
Private Flows, net	80.4	102.3	0.3	-27.6	0.2
Equity Investing, net	15.2	18.6	4.4	13.8	18.5
Direct Equity, net	4.2	4.7	5.9	9.5	12.5
Portfolio Equity, net	11.0	13.9	-1.5	4.3	6.0
Private Creditors, net	65.2	83.7	-4.1	-41.4	-18.3
Commercial Banks, net	53.2	62.7	-21.2	-36.1	-16.0
Nonbanks, net	12.0	21.0	17.1	-5.3	-2.3
Official Flows, net	2.7	-3.3	28.3	23.4	7.6
Int'l Financial Institutions	-0.3	-2.0	22.6	19.3	-1.7
Bilateral Creditors	3.0	-1.3	5.7	4.1	9.3

* Indonesia, Malaysia, Thailand, the Philippines, and South Korea

NOTE: e = estimated, f = forecasted.

SOURCE: Institute for International Finance "Capital Flows to Emerging Markets", April 1999.

money market instruments, and financial derivatives, generally accounts for a smaller portion of all capital flows. However, this type of investment grew substantially in Asia before the crisis. Whereas the classification of investments used to depend in part on the stated maturity of the investment—long-term investment having a stated maturity of more than one year—changes in financial markets have rendered that formal distinction of little importance. In today's markets, the original maturity of a security is much less important than its liquidity. FDI tends to be illiquid, whereas portfolio investments may be more easily converted to cash. Thus the net flows to Asia of less stable and more liquid portfolio equity turned from positive to negative in 1997.

15. IMF, *International Capital Markets*, September 1998, p. 13.

16. The investor only has to be able to influence or participate in the management of an enterprise. FDI is defined as ownership by a single foreign investor of 10 percent or more of the voting securities of a business enterprise. Absolute control is not required as under former definitions. We are using the working definition of FDI used by the OECD and the IMF, with the U.S. using the same definition (qualifications vary from country to country). See Robert E. Lipsey, "The Role of Foreign Direct Investment in International Capital Flows," NBER Working Paper #7094, p. 6.

17. IMF, *Balance of Payments Manual*, 5th ed, (Washington, DC: IMF, 1993).

Other highly liquid investments include: trade credit, loans from commercial and non-bank private creditors, financial leases, currency, and bank deposits. As seen in Table 2, those types of investments also can be easily reversed. The turnaround in private credit (bank and nonbank loans) between 1996 and 1998 was about \$125 billion.

Economic and Social Growth in Developing Countries

The transfer of capital to developing countries has boosted their economic growth and enabled improvement in social conditions, including health, literacy, and sanitation. As shown in Table 3, per capita economic growth in the last third of the 20th century has been positive for nearly all country groupings. Despite occasional downturns in economic activity, developing countries as a group have recorded impressive gains in per capita income over a long period. Growth in output and income has been particularly striking in

the East Asia and Pacific region. Only Sub-Saharan Africa has had a decline in per capita income over the period, as rapid population growth has outstripped relatively slow growth in GNP.

Higher economic growth means greater resources and opportunity. As income rises, expenditures on health, education, and sanitation also rise. Social indicators have improved in all regions since the 1970s, but to varying degrees. Table 3 highlights selected health and education indicators in developing country regions for the last two to three decades. Infant mortality, life expectancy at birth, secondary school enrollment, and youth illiteracy all show significant improvement.

Economic growth in developing countries not only benefits them directly, but provides benefits to the larger global economy. When incomes rise, imports from countries such as the United States tend to rise also. In addition, countries with rising incomes may have a greater interest in achieving agreements on global

TABLE 3

Selected Economic, Health and Education Indicators, By Region

	Real GNP Growth 1965-1997 (annual average)	Infant Mortality Rate ¹		Life Expectancy at Birth		Secondary School Enrollment ²		Youth Illiteracy Rate (female)	
		1970	1997	1970	1997	1980	1996	1980	1997
Sub-Saharan Africa	-0.2	137	91	48	51	15	27	55	29
Latin America and Caribbean	1.3	84	32	65	70	42	52	11	6
Middle East and N. Africa	0.1	134	49	53	67	42	64	52	27
East Asia and Pacific	5.4	79	37	65	69	43	69	15	4
South Asia	2.3	139	77	54	62	27	48	64	48

¹per 1000 live births

²percent of relevant age groups

SOURCE: World Bank, *World Development Indicators*, 1999, various tables.

goals, such as improvement in environmental conditions, respect for human rights, and non-proliferation of nuclear weapons. The validation of the value of democratic institutions is one of the notable benefits of economic development in the latter part of the twentieth century.

MAJOR CHARACTERISTICS OF RECENT FINANCIAL CRISES

In the 1990s, many developing countries removed restrictions on both the import and export of capital. While the goal was sound, in many cases the implementation created problems because domestic institutions, especially banks and their regulators, were unprepared for the new conditions. Thus, well-meaning reforms created new instabilities and ultimately paved the path for financial crises. The challenge for policy makers now is to secure the benefits of freer financial markets while reducing the instabilities that such freedom can create.

Periodic financial crises have been a feature of capitalism since its inception. However, starting with the Mexican peso crisis that began in December 1994 and stretching through the crises that rolled through East Asia, Russia, and Brazil, we appear to have entered a new era. Crises now are more likely to be driven by sudden capital account outflows triggered by a change in investor expectations than by poor economic fundamentals.¹⁸ In the past, crises tended to be caused by inconsistent policies in an overheated economy. For example, a country might have tried to maintain a fixed exchange rate while it ran persistently large fiscal deficits and expanded the money supply. Over time, that combination of policies would have eroded the country's international reserves and its ability to defend a pegged exchange rate. At that point, the government would have had to either devalue

the currency or raise interest rates to contract the economy.

Today's financial crises are more often caused by self-fulfilling expectations about currency devaluations. Now, it takes only a change in expectations by currency traders about the government's commitment to the maintenance of a fixed exchange rate to produce a sharp and sudden reversal in capital flows, even if the economy appears to have sound economic fundamentals. A sudden shift in market expectations about a country's commitment to a pegged exchange rate can easily and quickly trigger a speculative attack that makes the pegged exchange rate impossible or too costly to maintain.

The increased scale of capital flows is significant for a number of reasons. First, it has increased an economy's vulnerability to sudden capital outflows. The more dependent an economy is on the inflow of external capital, the more vulnerable it is to a sudden shift in that flow. Second, it has increased the scale of resources needed to stabilize an economy in financial crisis. Third, due to the greater involvement of foreign private-sector lenders and investors, the financial relationships that need to be untangled in the event of a default have become more complex. Both the increase in the scale and the complexity of outside linkages heighten concern about the contagious spread of a financial meltdown from one country to others and the potential for greater system risk. As put by one economist:

"Financial crises once made most people's eyes glaze over; they were subjects of intense interest only to a limited clientele many of whom wore green eyeshades. Not any longer. The topic has unfortunately acquired a mass audience in the second half of the 1990s. Stunning currency collapses in Mexico (1995), southeast Asia (1997), Russia (1998), and Brazil (1999) have pushed the subject to the front page. Financial conflagrations have become too fre-

18. IMF, *World Economic Outlook*, May 1999, p. 68.

quent, too devastating, and too contagious to be ignored.”¹⁹

Frequency

Analysis by the IMF shows that, while financial crises have occurred frequently during the 1990s, they are no more frequent than during previous decades.²⁰ Looking at the period 1975 to 1997, it found 158 episodes in which countries experienced currency crises and 55 episodes of banking crises. A currency crisis was defined as a devaluation (or sharp depreciation) of a currency, or a sharp rise in the interest rate or decline in international reserves in response to a speculative attack on the exchange value. A banking crisis was defined as a situation where actual or potential depositor runs compelled banks to suspend payment on their liabilities (deposits) or where the government intervened to prevent that from happening.²¹ The number of currency crises was particularly high in the mid-1970s and mid-1980s due first to oil price shocks and then to the Latin American debt crises. Banking crises were more prevalent after the early 1980s. The IMF study also found that the incidence of crisis was twice as great for emerging market countries as for developed countries.

Cost

The IMF’s analysis, however, also shows that crises have become more costly.²² A useful measure of the cost of a financial crisis is the estimated loss in output (GDP) compared with its trend growth. As shown in Table 4, on average, countries experiencing a currency crisis had a cumulative loss in output relative to trend of 4.3 percent and a recovery time of about 1.6

years. For countries experiencing a combined currency and banking crisis, output loss was 14.4 percent, on average, and recovery time stretched to 3.2 years. In its analysis of the costs of the Asian crisis, the IMF calculated the cumulative output losses for Indonesia, Korea, Malaysia, and Thailand to range between 27 and 82 percent (see Table 5, page 14). These losses tended to be much higher than those of Mexico and Argentina during the so-called tequila crisis of 1994/95.

The heavy costs of crises are also reflected in other socio-economic data. For example, the unemployment rate increased by three to five times its pre-crisis levels in Asia, rising from about 3 percent to over 15 percent in Indonesia, 2 percent to 8 percent in Thailand, and 2 percent to 7 percent in Korea.²³ Real wages fell 25 to 35 percent in Indonesia and 10 percent in Korea.²⁴ The World Bank estimates that more than 20 million people in East Asia fell into poverty as a result of the crisis.²⁵ Expenditures on social safety net measures are estimated to have doubled in Thailand and Indonesia, leading to deterioration in the fiscal balance of about 1 percent of GDP. Bank restructuring is estimated to add to the fiscal burden by another 1 to 3 percent, depending on the individual country.²⁶

Contagion

Perhaps the most worrisome aspect of recent crises is the increase in contagion—the spread of crisis from one country to another. Contagion is indicated if crises are concentrated in time or concentrated geographically. If contagion were not a factor, one would expect to see crises distributed relatively evenly in time and location. However, research by the

19. Alan Blinder, “Eight Steps to a New Financial Order,” *Foreign Affairs*, Vol. 78, No. 5, p. 50.

20. IMF, *World Economic Outlook*, May 1998, pp. 76-79.

21. The IMF also included in the definition of a currency crisis situations when a country was forced to defend its currency by expending a large volume of international reserves or sharply raise interest rates to defend its currency instead of devaluing it. IMF, *World Economic Outlook*, May 1998.

22. IMF, *World Economic Outlook*, May 1998, pp. 78-79.

23. ILO data; cited in World Bank, *Global Economic Prospects*, 1999, p. 105.

24. Joseph Stiglitz, “Back to Basics: Policies and Strategies for Enhanced Growth and Equity in Post-Crisis East Asia,” Speech, Bangkok, Thailand, July 29, 1999.

25. James Wolfensohn, “The Other Crisis,” Address to the Board of Governors of the IMF and World Bank, October 6, 1998.

26. IMF, *World Economic Outlook*, October 1999, pp. 79-80.

IMF shows that during the 1990s, crises were clustered in time around four major periods.²⁷ In addition, crises tended to affect neighbor-

ing countries more than distant ones. The breakdown of the European Exchange Rate Mechanism (ERM) primarily affected European industrial countries and emerging markets in the Middle East and Africa; the Mexican crisis was felt mostly in Latin America; the Asian crisis spilled over mostly to other Asian countries; and the Russian crisis affected eastern European countries and some countries out-

27. IMF, *World Economic Outlook*, October 1999. The analysis is of currency crises; it is based on the construction of an index of changes in exchange rates and foreign exchange reserves. The ERM crisis occurred during September 1992 through February 1993; the Mexican crisis, December 1994 through May 1995; the Asian crisis, July through December 1997; and the Russian crisis, August through November 1998.

TABLE 4

Costs of Crises in Lost Output Relative to Trend

	Number of Crises	Average Recovery Time ¹ (in years)	Cumulative Loss of Output per Crisis ² (in percentage points)	Crisis with Output Losses ³ (in percent)	Cumulative Loss of Output per Crisis with Output Loss ⁴ (in percentage points)
Currency crises	158	1.6	4.3	61	7.1
Industrial	42	1.9	3.1	55	5.6
Emerging market	116	1.5	4.8	64	7.6
Currency crashes⁵	55	2.0	7.1	71	10.1
Industrial	13	2.1	5.0	62	8.0
Emerging Market	42	1.9	7.9	74	10.7
Banking crises	54	3.1	11.6	82	14.2
Industrial	12	4.1	10.2	67	15.2
Emerging Market	42	2.8	12.1	86	14.0
Currency and Banking crises⁶	32	3.2	14.4	78	18.5
Industrial	6	5.8	17.6	100	17.6
Emerging Market	26	2.6	13.6	73	18.8

¹Average amount of time until GDP growth returned to trend. Because GDP growth data are available for all countries only on an annual basis, by construction the minimum recovery time was one year.

²Calculated by summing the differences between trend growth and output growth after the crisis began until the time when annual output growth returned to its trend and by averaging over all crises.

³Percent of crises in which output was lower than trend after the crisis began.

⁴Calculated by summing the differences between trend growth and output growth after the crisis began until the time when annual output growth returned to its trend and by averaging over all crises that had output losses.

⁵Currency "crashes" are identified by crises where the currency component of the exchange market pressure index accounts for 75 percent or more of the index when the index signals a crisis.

⁶Identified when a banking crisis occurred within a year of a currency crisis.

SOURCE: Replicated from IMF, *World Economic Outlook*, May 1998, p. 79.

TABLE 5**Cumulative Output Losses of 1990s Crises**

(in percent of potential output)

	Cumulative Four-Year Output Loss ¹
“Tequila Crisis”	
Argentina	15
Mexico	30
Asian Crisis	
Indonesia	82
Korea	27
Malaysia	39
Thailand	57

¹Calculated as the sum of the output gap over a four-year period, starting with the crisis year. The output gap is defined as the percentage difference between the actual and the hypothetical (or potential) level of real GDP for each country.

SOURCE: Replicated from IMF, *World Economic Outlook*, October 1999.

side the region, notably Brazil and other countries in Latin America.

Several factors account for such contagion. Herd behavior by investors is an explanation that has often been cited. Such behavior has been attributed in part to the increased integration of international financial markets, which can weaken the incentives for individuals to gather information independently and strengthen the tendency to follow market leaders. Other factors that contribute to contagion include “trade spillovers” resulting from a sudden change in price competitiveness and decline in income that occurs when a crisis country suddenly devalues its currency; “financial spillovers” that occur when investors decide to sell financial assets in other countries, either to raise cash to cover losses elsewhere or simply to reduce exposure to risk; and shifts in investor sentiment that result from a reassessment of countries’ fundamentals in the wake of a crisis elsewhere.

Contagion does not have to induce a crisis to be costly. Countries can experience a slowdown of growth without slipping into recession, and the value of lost output (relative to what might have been produced) should be counted as a cost. The IMF has estimated the decline in world economic growth after the Asian crisis, taking into account both the direct costs incurred by crisis countries and the indirect costs of slower growth elsewhere caused by trade and investment linkages. These estimates show world economic growth lower by 1.8 percentage points in 1998, 1.0 percentage point in 1999, and 0.5 percentage points in 2000. With world GDP estimated to be about \$39 trillion in 1998 (valued at purchasing power parity), the decline in growth translates into a cumulative economic loss of over \$1.1 trillion worldwide during these three years.

THE NEED FOR GREATER STABILITY IN GLOBAL FINANCIAL MARKETS

Overall, the globalization of financial markets holds the promise of higher income for both capital exporting and capital importing countries. However, that promise may not be fulfilled unless greater stability can be achieved. In addition to the economic losses discussed above, economic instability creates at least two additional and less obvious costs. The first is economic; financial crises cause individuals to become less certain about their future incomes and consequently to reduce their living standards by saving more.²⁸ The second is more political—an erosion in support for open international trade and investment. The challenge for policy makers is to lower these costs by putting the international financial system on a more stable footing.

From a political perspective, economic volatility is likely eventually to diminish support for

28. IMF, *World Economic Outlook*, May 1999, p. 80.

the system that produces it. Perhaps one of the most remarkable features of the recent financial crises is that, for the most part, support for market-based reforms and for international trade and investment does not seem to have diminished in most emerging market economies. These countries have in general maintained their support for foreign direct investment and in some cases, such as banking, even opened their doors further to foreign participation. Nevertheless, it cannot be expected that support will continue if economic conditions, which have improved significantly in most of the crisis countries, begin to deteriorate again, or if such crises are repeated.

CHAPTER 3

BUILDING INSTITUTIONS TO WORLD-CLASS STANDARDS



Most emerging market countries have ample room to improve their domestic institutions and economic policies. Countries that want to prosper must foster economic, regulatory, and political institutions and practices that create stability and integrity, while allowing markets to allocate resources efficiently, adapt to changing conditions, and facilitate growth.

Governments often find it difficult to establish domestic policies and institutions that provide the right combination of marketplace freedoms with the government oversight and regulation necessary to overcome market failures. Finding the “right” combination is no easy task. In fact, it defines many of the major struggles between political parties in nearly every market-based economy in the world. Certainly, no country—not even the United States—can claim to have found the ideal balance between those competing goals. However, the systems that have been developed in the United States and other major mature economies have provided substantial stability and integrity and the basis for sustained long-term economic growth. Most emerging market nations have not yet built institutions sufficiently strong to foster growth and maintain stability simultaneously. The difficulty of their task should not be underestimated.

One place to start is to root out corruption and bribery from the basic institutions of government. The experiences of many businesses operating in developing countries are confirmed by surveys, such as those conducted by Transparency International, which show ram-

pant corruption and bribery in many of the leading emerging market countries.²⁹ Little progress will be made in improving government institutions and practices until corruption and bribery are curbed.

Another important step is to adopt and apply international codes of conduct based on established and transparent standards and best practices. **CED encourages developing countries to adopt and apply international codes of conduct based on established and transparent standards and best practices to help build and improve their economic and political institutions.** The “best practice” approach is being promoted by official bodies, such as the Group of Seven (G-7) industrialized nations, and by private-sector institutions, such as international professional associations. **We support on-going efforts to codify such standards and the greater use of private-sector resources, including for-profit enterprises, volunteers, and paid technical experts, to help developing countries raise their standards of practice.**

This approach recognizes the right of each nation to set its own laws while it employs market forces to encourage compliance with international standards. Each sovereign nation, with its own culture, traditions, values, and politics, must forge policies that meet its unique circumstances. International institutions can ad-

29. Transparency International, “Press Release: New Poll Shows Many Leading Exporters Using Bribes,” October 26, 1999, Berlin, Germany. Website at http://www.transparency.de/documents/cpi/cpi-bpi_press-release.html

vise, assist and otherwise support those policies, but the responsibility for implementing and maintaining them rests (and should rest) with each nation. However, the incentive for a country to comply with international standards is clear. Countries that adopt and adhere to these international standards will gain twice. They gain first from the direct improvements in economic efficiency that the application of these practices will achieve, and second from more and cheaper foreign private capital from lenders more willing to supply funds to countries that adhere to recognized international standards.

Discussions of codes of conduct and standards of practice have taken place in a variety of settings, including the IMF, the Bank for International Settlements, the International Organization of Securities Commissions, the International Association of Insurance Supervisors, the International Accounting Standards Committee, the International Federation of Accountants, and elsewhere. In part, the goal of such codes is to provide guidance to both governments and businesses, signal their compliance with recognized practices, and apply market pressure to raise standards. The existence of standards of good practice sends important signals to both officials in the emerging market countries and investors in the developed countries. Officials in the emerging markets learn what steps they must take to satisfy international investors; investors learn whether conditions in a particular country meet their expectations.

Significantly, many standard-setting institutions are private-sector organizations. Private-sector groups that develop “best practices” in their areas of expertise bring knowledge and practical experience to the process. In addition, members of these groups with specific expertise are uniquely positioned to help developing countries implement new practices by working with business and professional counterparts in those countries. By developing partnerships, facilitating information exchange, and volunteering to train others, business leaders

and professionals in the U.S. and other industrialized countries can help promote and transfer best practices.

However, it is essential to get “best practices” right. Substantial criticism has been directed at the 1998 Basle Capital Accord, which set a standard for the adequacy of bank capital reserves based on assigning risk weights to classes of assets. Such a system can distort decision-making if meeting the regulatory targets becomes the goal. The Basle capital standards may have contributed to the East Asian crisis by inappropriately assigning very low risk weights to short-term interbank loans and loans to sovereign entities, especially in the case of Korea. (Korea earned a zero risk weighting after it became a member of the OECD.) The Basle Committee has now published a draft proposal for new standards that would improve the method by which bank supervisors evaluate the risks of bank loans.³⁰ Any standard setting process should incorporate such continuous improvement.

The development of international standards and codes of practice is taking place in nearly 50 separate policy areas, including areas as diverse as accounting, ethics, and tax collection. We highlight briefly below a few of the major efforts underway to improve transparency and accountability, bankruptcy, financial supervision, corporate governance, and social policy.

TRANSPARENCY AND ACCOUNTABILITY

One of the most significant, and perhaps easiest, steps that a country can take to improve its economic climate is to increase the transparency and accountability of both government and private institutions. Transparency refers to a process by which timely information

30. Basle Committee on Bank Supervision, “A New Capital Adequacy Framework” (Bank of International Settlements, June 1999).

about existing conditions, decisions, and actions is made accessible, visible, and understandable. Reliable information is a necessary ingredient for good decision-making and is especially important to investors. Accountability refers to the need to justify and accept responsibility for decisions taken.³¹ Increased transparency and accountability will improve resource allocation by providing more and better information to all participants.

Public Sector. One of the key problems contributing to past crises was the lack of good information about such economic fundamentals as the state of government finances, the growth of credit, and the size of foreign currency reserves. In some instances, governments apparently hid unfavorable information. In other cases, governments themselves simply lacked the basic information needed to make sound policy decisions.

Several efforts are underway to help countries produce and disseminate information about government monetary and fiscal conditions. For the most part these activities are being carried out by the IMF with national authorities. IMF actions build on Article IV consultations and their recently initiated programs for strengthening data dissemination, the Special Data Dissemination Standard (SDDS) and General Data Dissemination System (GDDS). Taken together, these programs encourage countries to meet established guidelines for international reserves, external debt and other economic indicators, to improve their internal reporting on key economic variables, and to make more information available to the public on both their economic conditions and IMF programs and recommendations for improvement. Notably, the IMF is working on both a code of “Good Practices on Fiscal Transparency” and a code of “Good Practices on Transparency in Monetary and Financial Policies.”

31. G-22, “Report of the Working Group on Transparency and Accountability,” October 1998.

Private Sector. Significant gaps also exist in reporting by private-sector entities, and especially by hedge funds, other highly leveraged institutions, and non-bank financial institutions. Much of the work in this area is appropriately being undertaken by public and private-sector bodies with existing responsibilities for setting standards in such financial activities as accounting, banking, insurance, and securities. In addition, the newly formed Financial Stability Forum—a group charged with enhancing international cooperation and coordination in financial market supervision—is expected to report on the difficult issues surrounding highly leveraged institutions, offshore financial centers, and short-term capital flows.

Disclosure and transparency become more difficult to enforce when transactions, such as derivatives and swaps, are taken off balance sheets and performed by financial institutions that are not generally as regulated as banks. In today’s global financial market, no single type of financial institution should be allowed preferential treatment just because the task of securing useful information is difficult. The importance of off-balance sheet financial transactions and other activities of highly leveraged institutions and non-banks demands that both public-sector and private-sector authorities, such as the International Accounting Standards Committee and the International Organization of Securities Commissions, find some means by which markets can become informed of their activities. Such information is required by both market participants and monetary authorities to evaluate an institution’s financial viability and its potential to threaten system stability. The collapse of the Long-Term Capital Management hedge fund makes the case for such reporting. **The United States and other developed countries should act, either individually or collectively, to create standards that would provide better public information about the financial condition of highly leveraged financial institutions.**

BANKING AND OTHER FINANCIAL REGULATION

Bank supervision should be strengthened, and governments should remove impediments to the operation of foreign banks in competition with domestic institutions. Governments should refrain from providing explicit or implicit guarantees of private investments and from using the banking system to guide investments.

Banks play a key role in maintaining—or upending—financial balance. Bank lending is important in allocating resources within the economy, and when banks borrow abroad, they are an important conduit of foreign funds into the domestic economy. But banks are a potential weak point in the financial system because the structure of their assets and liabilities leaves them susceptible to a loss of confidence by depositors. Banks' liabilities (deposits) are typically payable on demand, while their assets (loans and other long-term commitments) are relatively illiquid. Thus, banks may have trouble meeting their short-term obligations if they must redeem too many of their liabilities within a narrow time span. Because banks maintain financial linkages with other banks—both domestic and foreign—such liquidity problems can rapidly spread and grow. As a result, the world banking system is inevitably a vulnerable component of the world economy.

All countries need to improve the operation of banking and other financial markets. In the developed economies, the primary problem is to ensure that creditors do not take undue risks. While that problem is also important for the developing economies, the more general issue for them is how to achieve standards of best practice, especially with regard to monitoring exposure to short-term debt.³²

32. An ancillary benefit of improved bank supervision in both developed and developing countries is that better reporting and monitoring of money laundering and other suspicious activities could help curb fraud and corruption.

It seems clear, in retrospect, that investors and creditors in the developed economies have, in many cases, underestimated risks as they reached for higher yields in emerging markets. Reform efforts are underway in a number of forums, but primarily through the Basle Committee on Banking Supervision and the Financial Stability Forum. Those efforts are directed at improving risk assessment and risk management, understanding better the operations of highly leveraged institutions, and encouraging offshore financial centers to comply with international standards.

In developing countries, the emphasis has been on improving fundamentals, such as the regulation of banks to ensure safety and soundness. **One significant step that governments should take is to remove impediments to the operation of foreign banks in competition with domestic institutions.** As foreign banks enter a country they tend to raise the standard of practice of domestic institutions through competition. Foreign banks are also likely to be less susceptible to domestic political pressures to which local banks are subject and more able to base lending decisions on the financial soundness of projects.

Another key element in strengthening financial market stability is the work of the Basle Committee, which is helping countries to comply with the “Core Principles for Effective Banking Supervision”. The main provisions of the “Core Principles” are outlined in Box 1, page 20. In addition, the IMF has developed a framework for financial sector surveillance that will allow IMF staff to better analyze and support member country programs of bank supervision in the context of Article IV consultations.

BANKRUPTCY

The lack of adequate bankruptcy procedures in many emerging market countries at best impedes and at worst stymies the resolution of financial crises. When creditors lack confidence in the fair enforcement of bankruptcy proce-

dures, they have an increased incentive, at the first sign of financial distress, to liquidate their claims before others do so. This behavior, when generalized, adds to financial distress and panic. In the event of an actual default, a lender's inability to repossess collateral under bankruptcy procedures may put it in financial jeopardy or even default. When the creditor is a bank, the potential for financial crisis is heightened.³³

CED urges developing country governments to establish bankruptcy procedures that are

transparent and even-handed. These procedures should allow the claims of creditors to be discharged fairly and provide the basis for the reemployment of productive assets and the continuation of viable enterprises. Domestic and international creditors of an insolvent or bankrupt institution should receive equal and fair treatment in any workout or debt restructuring.

Efforts have been underway since 1997 to encourage countries to adopt a version of a model law, developed under the auspices of the United Nations Commission on International Trade Law, that deals with specific problems of cross-border insolvencies—promoting, among other things, nondiscrimination against

33. Barry Eichengreen, *Toward a New International Financial Architecture* (Washington, DC: Institute for International Economics, February 1999) p. 28.

BOX 1: BASLE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

In 1997, the Basle Committee on Banking Supervision, in collaboration with supervisory authorities in fifteen emerging market countries, developed twenty-five minimum conditions for an effective bank supervisory system. These Core Principles for Effective Banking Supervision are now widely endorsed by central bank Governors and supervisory authorities throughout the world. They are intended to serve as a basic reference for public authorities worldwide to apply in the supervision of all the banks within their jurisdictions.

The Core Principles are summarized below.

Preconditions for Effective Banking Supervision

There should be clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each agency should possess operational independence and adequate resources. A suitable legal framework is also necessary, as are arrangements for sharing information between supervisors and protecting the confidentiality of such information.

Licensing and Structure

The activities of institutions that are licensed

as banks must be clearly defined, and the licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards. Banking supervisors should review any changes in the ownership or controlling interests of existing banks, major acquisitions or investments by a bank, and corporate affiliations and structures so the bank is not exposed to undue risks.

Prudential Regulations and Requirements

Regulators must set prudent and appropriate capital adequacy requirements for all banks. Those requirements must reflect the risks banks undertake and must define the components of capital. For internationally active banks, these requirements must not be less than those established in the Basle Capital Accord.

Banking supervisors must evaluate a bank's policies, practices and procedures for: granting loans and making investments; managing loan and investment portfolios; evaluating the quality of assets; maintaining adequate loan loss provisions and loan loss reserves; and identifying, monitoring, and controlling market risks in domestic lending and country risks in their international lending and investment activities.

There should also be adequate information

foreigners in bankruptcy proceedings. (See Box 2, page 22.) In addition, the World Bank has been assisting governments by providing information on insolvency systems, including the role of bankruptcy courts. Finally, the International Bar Association's Committee on Insolvency and Creditor Rights (Committee J) has developed the Cross-Border Insolvency Concordat, which provides a framework for cooperation in multilateral insolvencies.

CORPORATE GOVERNANCE

In most developing countries, domestic laws regulating corporate governance are inadequate and need to be improved. **CED be-**

lieves that governments should establish clear and viable rules to define the agency relationship between managers and shareholders and protect the rights of shareholders. The rights of minority shareholders of corporations that are predominantly family-owned or part of a larger cross-ownership group should be protected.

Corporate governance laws provide the structure through which the objectives of the corporation are set and the means by which those objectives and the monitoring of performance are determined. Because recent financial crises have roots in the borrowing behavior of domestic firms and banks, corporate governance has significantly affected the extent of

systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

There should also be high ethical and professional standards in the financial sector to prevent the bank from being used, intentionally or unintentionally, by criminal elements. There should also be adequate internal controls.

Methods of Ongoing Banking Supervision

Banking supervisors must have: regular contact with bank management; thorough understanding of the institution's operations; a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks; and a means of independent validation of supervisory information either through on-site examinations or use of external auditors. Banking supervisors should also be able to supervise the banking group on a consolidated basis.

Information Requirements

Each bank should maintain adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the

financial condition of the bank. The bank should publish on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors

Banking supervisors must have adequate measures to take corrective action when banks fail to meet prudential requirements, when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

Cross-border Banking

Banking supervisors must practice global consolidated supervision over their internationally active banking organizations. A key component of this is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities. Local operations of foreign banks must be held to the same high standards as are required of domestic institutions.

SOURCE: Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Basle, Switzerland: Bank of International Settlements, September, 1997).

BOX 2: MODEL LAW ON CROSS-BORDER INSOLVENCY

The United Nations Commission on International Trade Law (UNCITRAL) approved the “Model Law on Cross-Border Insolvency” in May 1997. The document was drafted after two years of discussions among delegates from 40 countries.

The Model Law is designed to provide countries with a modern, harmonized, and fair framework for handling cases of cross-border insolvency. Most national insolvency laws are poorly equipped to deal with bankruptcy proceedings with foreign creditors or debtors. As a result, different or incompatible legal approaches stall or prevent the rescue of financially troubled businesses, threatening investment and employment.

The provisions of the Model Law will help to promote:

- Cooperation between the courts and other authorities of domestic and foreign countries;
- Greater legal certainty for trade and investment;
- Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor;
- Protection and maximization of the value of the debtor’s assets; and
- Facilitation of the rescue of financially troubled businesses.

The law is a legislative text, which can be incorporated, in whole or in part, into a country’s existing national insolvency law.

SOURCE: UNCITRAL, “Model Law on Cross-Border Insolvency with Guide to Enactment,” available at www.uncitral.org/english/texts/insolven/ml+guide.htm. See also Deborah Pines, “International Bankruptcy Law Proposed,” *New York Law Journal*, November 17, 1997.

the financial problems nations have faced.³⁴ To be effective in monitoring and controlling the management of a firm and to hold it accountable for its actions, shareholders must have the right to reliable information about the firm and the right to vote their shares. With laws that protect the rights of minority shareholders, a country can build on market incentives to check overly risky behavior or other behavior on the part of managers and other insiders that could not withstand public scrutiny.

The World Bank has led efforts to promote standards and best practices related to laws and regulations affecting corporate governance. In particular, Bank projects have supported corporate governance reforms in client countries. Another prominent force for change is the Organization for Economic Cooperation and Development (OECD). The OECD’s Business Advisory Group on Corporate Governance issued a report in 1998 that identified principles of sound corporate governance.³⁵ These principles are outlined in Box 3. In addition, the OECD is developing guidelines to improve practices in member countries and serve as a reference point for nonmember countries.

In order to promote principles of corporate governance, the OECD and the World Bank have joined to create the Global Corporate Governance Forum, which provides a framework for design and implementation of corporate governance projects by participating countries and institutions. The Forum will build partnerships between public and private-sector actors by inviting key private-sector figures from developed and developing countries, and various stakeholders from non-governmental organizations (NGOs), labor organizations, and human rights groups to participate in its meetings. Two important initiatives already under-

34. Kenneth Scott, “Corporate Governance and East Asia,” paper presented at the World Bank Group-Brookings Conference, “Preventing Crises in Emerging Markets”, March 26-27, 1999, New York City.

35. OECD, *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*, (OECD, 1998).

way are the Investor Responsibility Taskforce, which encourages investors to pay more attention to corporate governance issues to increase the flow of funds to countries making progress on reforms, and the Audit and Accounting Taskforce, created to raise standards worldwide.

SOCIAL POLICY

Good social policy is important and beneficial to the economic health of a country in

both crisis and non-crisis times. As described by the G-7 Finance Ministers, “effective social policy will help provide a foundation for sustainable development, by ensuring that the benefits of globalization are widely shared, equipping people for change and ensuring that economies are more robust.”³⁶

Effective social safety nets are an integral part of crisis resolution. In fact, there is a strong

36. Report of the G-7 Finance Ministers to the Köln Economic Summit, *Strengthening the International Financial Architecture* (Cologne: June 18-20, 1999).

BOX 3: OECD PRINCIPLES OF CORPORATE GOVERNANCE

The Asian financial crisis heightened awareness of the importance of good corporate governance, as well as the need for international standards in this area. To address this need, the Organization for Economic Cooperation and Development (OECD) has developed the “Principles of Corporate Governance.”

The Principles, meant to be useful to OECD member and non-member countries alike, are an outline of the basic conditions for governments and private-sector participants to refer to as they evaluate their own “legal, institutional, regulatory, and company-specific frameworks.” The principles are non-binding and leave flexibility for implementation according to specific circumstances.

The term corporate governance describes the relationships between a company’s management, its board of directors, shareholders, and other stakeholders, the rules and incentives which guide these relationships, and the structure through which the objectives of the company are met. Key aspects of good corporate governance include transparency of corporate structures and operations, accountability of management to shareholders, and corporate responsibility towards employees, creditors, and the communities in which the company operates.

The Principles fall under five broad categories:

The rights of shareholders: all shareholders

should have and utilize their access to relevant information, ability to influence the behavior of the corporation, and voting rights.

The equitable treatment of shareholders: all shareholders (including foreign shareholders) should be treated fairly by board members, management, and controlling shareholders; and insider trading and self-dealing should be prohibited.

The role of stakeholders: good corporate governance should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Disclosure and Transparency: timely and accurate disclosure on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company is essential.

Responsibilities of the Board: the accountability of the board to a company and its shareholders, the effective monitoring of management by the board, and the strategic guidance of the company are essential to its functioning.

SOURCE: OECD, “Principles of Corporate Governance,” (OECD: June, 1999); available at www.oecd.org/daf/governance/principles.htm.

relationship between a country's ability to withstand economic setbacks, such as a currency crisis, and the strength of institutions designed to provide a safety net for those in need.³⁷ When a financial crisis hits, many of the most vulnerable segments of society are affected. Workers are unemployed and small businesses bankrupted. Typically, government revenues decline and expenditures shift to aid the financial recovery of banks and commercial businesses, leaving less public funds to be spent on social programs such as education, income support, and public health. **Countries need to establish more comprehensive social safety nets to better protect and assist vulnerable groups in time of crisis or significant economic transition.**

To protect the poorest groups in society, the World Bank has taken the lead in developing and identifying best practices in social policy. The Bank produced a draft note of Principles and Good Practices in Social Policy, and further development of these principles and practices has been delegated to the United Nations as part of the follow-up to the Copenhagen Declaration of the World Summit for Social Development. Such practices will both support economic development generally and provide the basis for ensuring the protection of the most vulnerable members of society as post-crisis adjustment programs are developed.

The IMF has also acknowledged the importance of social policy and poverty reduction. IMF adjustment programs are being examined to ensure that they provide adequate social spending in times of crisis. The IMF is collaborating with the World Bank on ways to ensure that the implementation of social safety nets is consistent with good fiscal policy and efficient

allocation of government resources. Even in its non-crisis lending to the world's poorest countries, the IMF has changed its Enhanced Structural Adjustment Facility (ESAF) to a Poverty Reduction and Growth Facility (PRGF) to link social and economic policies in its consultations with countries.

The international community also has initiated an effort to provide debt relief to the world's poorest countries that are so heavily burdened with debt payments, mostly to official creditors, that they are unable to break out of the cycle of poverty. The Heavily-Indebted Poor Countries (HIPC) Initiative, for which 36 nations are currently eligible, aims to help countries that pursue sound economic policies to reduce their external debt burden to sustainable levels.³⁸ At the same time, the initiative strengthens the link between debt relief and poverty reduction by integrating IMF-supported macroeconomic programs into broader poverty reduction efforts. Countries granted debt relief by bilateral creditors are expected to invest in poverty reduction programs such as health, education, and other programs addressing social needs. (See Box 4.) **CED urges developed country governments to grant relief from official debt and provide other forms of financial and technical assistance for the very poor countries that are trying to establish a foundation for economic growth through improved domestic policies.**

37. Rodrik, *The New Global Economy and Developing Countries: Making Openness Work*, pp. 82-98.

38. Forty-one countries are defined as Heavily Indebted Poor Countries, and thirty-six currently qualify for debt relief. The HIPC countries are: Angola, Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Cote D'Ivoire, Democratic Republic of Congo, Equatorial Guinea, Ethiopia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Kenya, Laos, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Myanmar, Nicaragua, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, Vietnam, Yemen, and Zambia. See IMF, "Debt Initiative for the Heavily Indebted Poor Countries (HIPC)", September 5, 1999. Available at www.imf.org/external/np/hipc/hipc.htm

BOX 4: DEBT RELIEF FOR THE POOREST NATIONS: THE HIPC INITIATIVE

In September 1996, the Interim and Development Committees of the IMF and the World Bank proposed a program to address the overwhelming levels of external debt strapping the world's poorest nations. The Initiative for the "Heavily Indebted Poor Countries" (HIPC) is designed to provide assistance to eligible countries following sound economic policies to help them reduce their external debt burden to sustainable levels within a period of six years.³⁹ In most eligible countries, 40 percent of the population lives below the poverty line.

The HIPC Initiative promises to deal with the ongoing debt crisis of the world's poorest economies by offering assistance in the form of a reduction in the net present value of claims on the indebted country. Such assistance will help to provide the incentive for investment and broaden domestic support for policy reforms. The intent of the program is to relieve countries of debt owed mostly to official bilateral and multilateral creditors—the G-8 developed countries, the World Bank, the IMF, and the regional development banks. Although little is owed to commercial lenders, the program urges them to forgive debt also.

To participate in the program, a country must implement a World Bank/IMF supported structural adjustment program, during a six-year period. At the "decision point", which marks the end of the first three years, creditors re-examine the country's debt and determine whether it can exit the HIPC scheme or, if it cannot, how much debt relief it will need to reach a sustainable level of debt at its "completion point", three years down the line.

Significant progress has been made in improving the program, particularly regarding

debt owed to multilateral creditors. In April 1999, the Boards of the IMF and the World Bank endorsed proposals to provide "faster, deeper, and broader" relief. Thirty-six countries now qualify for debt relief, and they will be eligible for interim relief between the decision and completion points, as well as the front-loading of the delivery of debt relief.

The most revolutionary aspect of the HIPC Initiative, and the most promising for meeting social policy goals in countries, is the strong link between debt relief and poverty reduction. Debt relief becomes an integral part of poverty reduction because each country participating in the HIPC Initiative is required to develop a *Poverty Reduction Strategy Paper (PRSP)* with the assistance of the Bank and Fund. The strategy must ensure consistency between a country's macroeconomic policies to foster economic stability and growth and its social policies, including actions targeted at reducing poverty, and improved access to primary health, education, and clean water for the poorest populations.

So far, 14 countries have entered the initiative, and four countries — Uganda, Bolivia, Guyana, and Mozambique—have reached their completion points with the IFIs. Following the establishment of a debt forgiveness plan by the G-8 Countries at the Köln Summit in June 1999, the United States and the United Kingdom pledged 100 percent official debt relief on loans to qualifying countries. Other G-8 countries are expected to make similar pledges.

SOURCE: IMF, "Debt Initiative for the Heavily-Indebted Poor Countries (HIPC)", September 5, 1999. See also "Statement of the G-7 Finance Ministers and Central Bank Governors", April 26, 1999, at www.g8cologne.de/06/02.

39. A sustainable level of debt has been defined by the World Bank/IMF as a level at which a country is able to meet its current and future debt repayment obligations in full without compromising economic growth and without resorting to rescheduling or building up arrears in the future.

CHAPTER 4

IMPROVING POLICIES BY RELYING ON MARKETS



This chapter focuses on three policy areas, each of which has become a focal point for efforts to help developing countries protect themselves and the broader international financial system from the causes and consequences of financial instability. These policy areas concern exchange rates, short-term capital inflows, and the treatment of debts to foreign private-sector lenders. Our recommendations for the first two of those policies are aimed at preventing financial crises. In the third policy area, our recommendation—which applies when a crisis has occurred—is aimed at ensuring the long-term flow of capital to developing countries.

CED's approach to these issues is based on our experiences as leaders of business. Accordingly, our recommendations are based on a strong preference for market-oriented solutions, not because of an ideological fealty to markets, but because markets effect adjustment to unavoidable change with least cost and maximum benefit. Markets do this in part because they transmit information rapidly and encourage decision makers to correct imbalances before they grow to crisis proportions.

Markets rely on accurate and timely information. Without such information, markets transmit false or misleading signals. Thus, the reforms recommended in this chapter depend on the success of reforms discussed in the previous chapter that enhance both the quantity and quality of information in developing countries through greater transparency and adher-

ence to international standards of data dissemination.

FOREIGN EXCHANGE REGIMES

The choice of exchange rate policy must be made by each sovereign nation based on its evaluation of relative benefits and costs. **However, CED believes that for emerging market economies that participate substantially in international capital markets, floating exchange rates are generally desirable.** They provide the best means of encouraging speedy and efficient adjustment to changing economic conditions. We recognize the benefits of a fixed exchange rate for a country that wants to curb rampant inflation and establish a stable monetary policy or is taking steps to establish a monetary union. However, we stress that a country that seeks to maintain a fixed exchange rate must establish the credibility of its commitment to sound macroeconomic policies. The institution of a currency board is one way to establish credibility, but ultimately it is the willingness to live with the consequences of a fixed-rate regime that demonstrates the extent of the commitment. **In addition, we recommend that whatever exchange rate regime a country chooses, it should build sufficient international reserves to weather crises and should seek to establish lines of credit with private lenders that can be called upon in case of emergency.**

Policy makers in developing countries should understand that the choice of exchange rate regime is but one element in the overall set of economic policies that a country must establish, including monetary policy and policies affecting the openness of capital markets. The overall set of policies should encourage non-inflationary economic growth, high employment, and efficient resource allocation. The exchange rate alone cannot meet all of these goals simultaneously.

A floating exchange rate, determined primarily by market conditions of supply and demand, has significant advantages for a large diversified economy with a relatively small part of its output engaged in international commerce, such as the United States. A floating rate allows a country greater independence in its monetary policy, at least in principle. In large economies, changes in the value of the currency have relatively small economic effects, especially since derivative markets in options and futures transactions allow exporters and importers to hedge against foreign exchange movements. Such hedging brings greater stability to the underlying real markets for goods and services, which are of primary concern.

Our support for flexible exchange rates for smaller economies results in part from the problems they have encountered with fixed rates. An advantage of a floating exchange rate is that it removes a potential source of excessive capital inflows, which occur when lenders (and borrowers) accept the government's pledge of a fixed exchange rate uncritically and underestimate the risk that the currency may be devalued. The illusory protection against devaluation given by a fixed exchange rate was a significant cause of the excessive inflow of short-term capital that set the stage for financial crisis in Thailand and other countries of East Asia. As it happened, governments were unable to maintain the fixed rate. The subsequent devaluations typically overshot and imposed high costs on the domestic economy when short-term capital left the country. In this manner, the countries of East Asia (and later Brazil,) were forced

to abandon their pegged exchange rate regimes and suffered declining production, high unemployment, and domestic inflation.

We believe that economic policy in developing countries, especially those that are actively engaged in international markets, can benefit from information conveyed by changes in the exchange rate. A sustained decline in the value of the currency often should signal to government leaders that fiscal and monetary policies might need to change. Another benefit is that forward currency markets will develop more fully as countries allow their currencies to float. These forward markets will facilitate hedging against the risk of change in a currency's value and bring more stability to the markets for traded goods and services.

We also believe that developed international capital markets allow floating exchange rates to provide many of the benefits previously attributed to fixed rates. The principal benefits traditionally credited to fixed exchange rates are lower transactions costs due to greater certainty regarding future prices and the discipline on monetary policy provided by the external commitment to maintain the rate. Now, however, well-developed forward exchange markets can lower transactions costs by allowing participants to insure the future value of a currency. In addition, a strong discipline on monetary policy is provided by the knowledge that an inappropriate policy will cause a sudden and large capital outflow, which (as noted above) will have a large impact on the exchange rate and interest rates, with large economic costs. Thus, for many countries, fixed rates provide few advantages over floating rates, but pose a greater risk of instability and crisis.

Despite our clear preference for floating exchange rates, we recognize that a fixed exchange rate may be warranted in certain circumstances.⁴⁰ Not all countries will be able to sustain a commitment to sound macroeco-

40. Jeffrey Frankel, "No Single Currency Regime is Right for All Countries or at All Times," NBER Working Paper #7338, September 1999, p. 9.

nomic policies without the discipline of a fixed exchange rate policy or the institutional structure that may be put in place to give that policy credibility. A fixed exchange rate has been used effectively by countries that needed to overcome hyperinflation or vulnerability to volatile fluctuations in the value of domestic currency. It has also been employed to bind together politically separate units (countries or states) that are, or want to be, economically integrated.

Our recommendation emphasizes that a fixed exchange rate policy must be credible to be effective. It is not the fixed rate, as such, that benefits the economy; commitment to a non-inflationary monetary policy provides the benefit. There are many ways to establish the credibility of that commitment. As pointed out above, a credible monetary policy can even be established under a floating rate regime—the United States has done so. For some countries, however, such credibility can only be established through a permanent institutional change. Argentina, for example, has had reasonably successful results since it adopted a currency board in 1991 to combat hyperinflation, although it was unable to use monetary policy to help pull itself out of a deep recession in 1999.⁴¹ In the case of Argentina and other countries that have adopted currency boards, what has made that policy work is the government's commitment to live with the economic consequences.

Some Latin American leaders have suggested going a step beyond the currency board to adopting the U.S. dollar as their nation's official currency, a step known as dollarization. That policy is much more controversial than a

currency board, because it would permanently cede monetary authority to a foreign country. In some circumstances, dollarization can benefit a country. However, it should not be viewed as a cure for a country's economic problems. Typically, many policy reforms, ranging from fiscal to structural, will need to be carried out to make dollarization a success. From the U.S. perspective, hemisphere-wide adoption of a single currency could hold substantial benefits, but the conditions for that step lie well in the future. (See Box 5, page 30, for a more complete analysis.)

CAPITAL INFLOWS

The economic crisis in East Asia prompted, almost immediately, a reexamination of the role that foreign capital—especially short-term capital—plays in emerging market economies. With fixed exchange rates, capital at first may flow too easily into a country and then, when conditions seem unfavorable, flow too easily out. When a substantial volume of capital suddenly flees a country, interest rates rise. At extremely high rates of interest—short-term rates reaching 25-50 percent are not uncommon—many economic activities become unprofitable. When firms cannot obtain working capital to finance inventory, they are forced to stop production and lay off workers. At the same time, the value of the nation's currency comes under overwhelming pressure, as the demand for foreign exchange outstrips the available supply. If the government attempts to defend the fixed-rate currency by raising interest rates or cutting back government expenditures, it reinforces the contraction in economic activity already under way.

Although governmental controls on capital flows tend to be anathema to investors, some forms of regulation of short-term capital inflows *may* be useful to shift the term structure of capital away from short-term obligations and dampen the size of very large inflows while a country is preparing itself for open capital markets. **CED believes that emerging market coun-**

41. A currency board only issues domestic currency to the extent that it is fully backed by foreign assets. The strict rules that govern the issuance of domestic currency by the currency board are needed to give the board credibility. In general, those rules include: an exchange rate that is fixed by law; a 100 percent reserve policy, stipulating that each dollar's worth of domestic currency be backed by a dollar's worth of reserves in the chosen anchor currency; and a self-correcting balance of payments mechanism, in which a payments deficit automatically contracts the money supply.

tries should strengthen their domestic financial systems and work toward the goal of open capital markets. However, a temporary tax on short-term capital inflows may help a country with a weak financial system to avoid economic damage associated with the volatility of short-term capital while it is engaged in reform.

The Argument for Unrestricted Capital Flows

As in any market, economic benefits arise when individuals are free to engage in capital market transactions. Barriers to such transactions create economic costs. At least three specific benefits arguably derive from international capital mobility: a more efficient allocation of resources, imposition of market discipline on the economy importing the capital, and diversification of risk for the capital-exporting economy. In addition, capital controls tend to be difficult to enforce. They can be circumvented in practice by a variety of evasions or illegal actions, often involving graft and corruption, which undermine the political and legal institutions generally.⁴²

The free international flow of capital allows financial resources to go to their most valuable use. That makes more efficient use of scarce resources and increases total economic output. Openness to capital flows lowers the cost of capital. Because most emerging market economies are characterized by a scarcity of capital and plentiful opportunities for investment, they typically need external capital. Between 1990 and 1997 net long-term private capital flows to developing countries surged from about \$42 billion to \$256 billion, as many of those countries dropped controls on capital and otherwise opened their economies to foreign investment. Gross flows during this period reached an annual rate of \$400 billion.⁴³

By opening its border to foreign capital, the receiving economy subjects itself to the discipline of international markets. Domestic projects seeking capital must compete with other projects around the globe for financing. That tends to improve the quality of the projects and their management. At the same time, the domestic government gets direct feedback from markets on the soundness of its economic policies as private investors signal their evaluation of the economic environment by investing or withdrawing their capital. Benefits also accrue to the capital exporting economy and its investors, since owners of capital can reduce risk by exporting capital to a diverse group of countries and increase profits by serving local markets.

The benefits associated in principle with the free flow of capital prompted the IMF Interim Committee (the committee of member-country finance ministers that oversees the operations of the IMF) to issue a statement endorsing capital account convertibility and, in particular, seeking to add IMF jurisdiction over capital account transactions to the IMF's Articles of Agreement.⁴⁴

Both economic theorists and practitioners, however, have challenged these claims that unfettered capital mobility produces large benefits. Theoreticians have argued that at least one of the chief benefits derived from international capital flows, greater efficiency in the allocation of global resources, is sometimes more illusory than real.⁴⁵ To the degree that developing countries do not have efficient markets, they may misallocate imported capital, negating the potential gain. In addition, experience has shown that, unlike free trade, free mobility of short-term capital can impose significant costs as a result of instability, as noted in Chapter 2.

42. See, for example, the comments of Richard Cooper at the IMF Economic Forum, "Capital Account Liberalization: What's the Best Stance?" October 2, 1998; at <http://www.imf.org/external/np/tr/1998/TR981002A.HTM>

43. Council of Economic Advisers, *Economic Report of the President*, 1999, p. 221.

44. The Hong Kong Declaration of the Interim Committee of the IMF, September, 1997.

45. See Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs*, May/June 1998, Vol. 77, No. 3; see also Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work*.

BOX 5. USE OF THE DOLLAR AS A DOMESTIC CURRENCY

Many policy makers and economic analysts have concluded that developing countries that seek to establish a credible fixed exchange rate regime will need to enact rules and mechanisms, such as a currency board, that firmly link issuance of domestic currency to a major foreign currency. The extreme form of such a linkage is to relinquish completely the use of the domestic currency in favor of a foreign currency. A specific suggestion by Argentine President Menem that his country might want to use the U.S. dollar as its domestic currency has given rise to substantial discussion and analysis of “dollarization.”

Dollarization is not a panacea for resolving any international financial issues. However, in some limited cases dollarization may be a valuable means for an emerging market nation to stabilize its monetary system. A country can dollarize without help from the United States. However, because it would lose seigniorage and it may want to ensure an adequate supply of currency, a country may seek the agreement of the United States.⁴⁶ **CED recommends that the United States employ a case-by-case approach to other countries’ desires to dollarize. CED supports the current policy, as articulated by the Federal Reserve and the Treasury, which clearly notifies countries that want to dollarize that they should not expect special consideration from the United States with respect to the conduct of monetary policy, bank supervision, or access to the discount window of the Federal Reserve.**

In essence dollarization is a domestic policy decision to establish a credible monetary policy by “importing” that policy from the United States. In itself, it does not affect the international financial system; its effects are mostly limited to the country that dollarizes and to the United States.

Considerations for the Dollarizing Country

Given the U.S. position, dollarization is a policy choice that other countries must make after evaluating its costs and benefits for their own economies. If unilaterally adopted,

dollarization would, on the one hand, mean complete surrender of monetary independence and the loss of seigniorage earnings, which could be a significant factor for some countries. On the other hand, it could help prevent the emergence of a financial crisis and lower the cost of credit.

One of the arguments in favor of dollarization for some countries is that the costs of doing so may be very low because the change would be small. Many countries already have a significant portion of bank deposits held in dollars: Panama and Liberia are fully dollarized already, ratios of 30-60 percent are common in the transition economies of Eastern Europe and the former Soviet Union, and Argentina is between 40 and 50 percent. In addition, to the extent that emerging market countries borrow abroad in dollars, their foreign liabilities are already denominated in dollars. Further, for countries that already have exchange rates that are fixed through a currency board, such as Argentina, the additional loss of policy flexibility implied by dollarization, would be small.

The other major argument, of course, is that the country will garner significant benefits from dollarization. Dollarization may add credibility and discipline to a country’s monetary policy. Analysts note that Panama is the only Latin American country with an active market for 30-year fixed rate mortgages. Argentine experts believe that dollarization would lower interest rates, which for peso deposits have averaged nearly 1.5 percentage points above equivalent dollar deposits over the past two years, and have gone as high as a 4 percentage point spread. Other benefits, in the form of closer trade and investment linkages to the United States are also expected.

Considerations for the United States

Some small direct financial benefits would accrue to the United States as a result of another country’s decision to use the dollar as its currency. These benefits are primarily in the form of seigniorage earned by the federal government on coin and currency in circulation.

For the United States those amounts would be small relative to the current amounts of such earnings and should probably not play a significant role in determining the U.S. attitude toward dollarization.

More important is whether the United States wants to accept or promote the increased economic and political linkages that are likely to follow as a consequence of dollarization. Sharing the same currency is likely to reduce the cost of trade and investment with countries that dollarize, in part because it eliminates risks due to exchange rate movements. In that context, economic policy makers in the United States almost certainly will come under pressure to adjust policy to meet the economic needs of countries that have dollarized. A political risk for the United States is that in difficult economic times elsewhere, the lost ability to control domestic monetary policy locally will direct resentment and blame to the United States, where monetary policy is made. That would produce new political tensions in a system that already must balance a large number of competing domestic political interests.

Two Final Notes

Dollarization advocates implicitly assume that U.S. monetary authorities will always follow a prudent course. We note that such an assumption is not based on the long historical record of the Federal Reserve, which has not always acted with the wisdom and steadiness shown by the current Fed Board and Open Market Committee.

We also note that conditions most conducive to dollarization are not present in countries that currently are considering it. The conditions for a successful common currency area are more like those in Europe than those of the Western Hemisphere today: a higher degree of labor mobility, free trade, exposure to common economic conditions (including external shocks), and the potential for stabilizing fiscal policy between regions with income disparities. Should those conditions develop in this hemisphere, we would view the adoption of a single currency as a positive event.

Regulating Short-Term Capital Inflows

Although we believe that developing country governments should work toward open capital markets and more efficient internal markets, we see several reasons why they may need to regulate the flow of short-term capital while they are strengthening their domestic markets. Governments are justified in such regulation when large short-term capital movements impose heavy costs on the larger society. As discussed above, the costs of a sudden large outflow of capital fall mostly on businesses and workers, who lose income and employment. The costs to the government, or taxpayers, are also high, as the cost of safety net programs, including deposit insurance and other financial rescue programs, rise. Costs are greater still when one includes the risk of contagion and transmission of the crisis to other countries. Since a crisis can be precipitated when the monetary authority is unable to meet the demand for foreign exchange, the government has an interest in ensuring that the term structure of foreign debt will allow it to meet that demand.

We are concerned, however, that a limit on short-term foreign borrowing alone may prove ineffectual or even lead to distortions in other financial instruments. Countries that regulate capital inflows should be aware that investors are wary of such regulations. The regulation of short-term capital flows is likely to be more effective when it is part of a fair, stable, and comprehensive strategy. Such a strategy would include improvements in the conduct of monetary policy and the regulation and supervision of the financial sector. The ultimate goal should be to strengthen the system and pave the way for open and uncontrolled capital markets.

46. Seigniorage is generally defined as the revenue derived from the difference between the cost of issuing coin and currency and its face value.

Controls on the inflow of capital should be used to encourage a longer holding period, rather than to regulate the purpose for which capital will be used. If administered as a tax, rather than as a quantitative restriction, inflow controls can allow continued access to foreign capital, and capital account convertibility can be maintained. Taxes, in general, distort economic efficiency less than quantitative controls and are an efficient means of recognizing hidden (or external) costs. In addition, after a tax is imposed, markets, rather than further government intervention, would allocate resources. Market allocation would result in sounder and more efficient resource allocation decisions. Furthermore, as will be discussed more fully below, a duration tax provides a simple way to make it more costly for foreign private-sector lenders to withdraw capital in anticipation of, or during, a financial crisis.

However, we strongly believe that, in most circumstances, only capital regulations on the *inflow* of capital, not the *outflow*, are desirable. Outflow controls have the effect of discouraging the inflow of all forms of capital, including foreign direct investment, because of the inability to repatriate profits. Their use can only be justified in exceptional and rare circumstances, such as to stem the illegal flood of money leaving a country, as in Russia, or as a temporary measure to halt a financial panic.

The most frequently cited example of a system that regulates the inflow of foreign capital is the one operated until recently by Chile. Although opinions vary with respect to the overall benefits provided by the Chilean system, it appears that Chile was able to discourage the inflow of short-term capital, to some degree, during the 1990s.⁴⁷

Starting in 1991, Chile's central bank imposed a tax on foreign debt in the form of a

required one-year non-interest-bearing deposit at the central bank of 20 percent of the loan. The reserve requirement provided a strong incentive for loans to be made for longer than one year. The requirement was subsequently raised to 30 percent and the coverage was extended to cover all foreign inflows except non-speculative foreign direct investment, which is of longer duration. Other forms of prudential regulation of banking and finance complemented the reserve requirement, and the policy was part of a broader strategy of economic reform in Chile. For example, except for trade credits, banks could not lend domestically in foreign currency. When all capital flows diminished in 1998, the reserve requirement was dropped to zero, but the system remains in place should it be needed again.

TREATMENT OF FOREIGN LOAN CONTRACTS

Perhaps the most contentious issue facing would-be reformers relates to the treatment of the private sector of the advanced industrial economies, the primary source of external capital flowing into emerging markets. Since the resolution of the Mexican crisis in 1995, many observers, official and unofficial, have proposed ways to force private-sector lenders to bear more of the costs of a crisis.⁴⁸ Proponents of such so-called bail-ins claim that the imposition of greater costs on foreign investors would serve at least three functions. First, it would mitigate the effects of moral hazard (discussed on page 33). Second, it would reduce the demand for scarce foreign exchange. Third, it would, to some, provide a more equitable distribution of the burden of adjustment between foreign and domestic interests.

47. A full examination of both the Chilean experience with capital controls and the economic literature assessing that experience is contained in IMF Working Paper WP/99/52, Francisco Nadal-De Simone and Piritta Sorsa, "A Review of Capital Account Restrictions in Chile in the 1990s," (IMF, April 1999).

48. See, for example, Report of the G-7 Finance Ministers to the Koln Economic Summit, *Strengthening the International Financial Architecture*, Barry Eichengreen, *Toward a New International Financial Architecture*, and Report of an Independent Task Force Sponsored by the Council on Foreign Relations, *Safeguarding Prosperity in a Global Financial System* (Washington, DC: 1999).

Bail-Ins and Moral Hazard

When the IMF and other crisis lenders, such as the United States, provide loans to a country in financial crisis, proceeds from the those loans may be used to pay off foreign currency debts to foreign private-sector lenders. Such loans have drawn substantial criticism because they are seen as a bailout for foreign lenders. In particular, critics claim that IMF loans increase the likelihood of future crises because private-sector lenders develop an expectation that they will be protected against losses. If lenders are always repaid, they may become less careful than they should be in evaluating loans and provide too much credit at high risk. Similarly, borrowers may become lax in evaluating their credit needs and the consequences of not keeping up with payments. These attitudes, which have come to be known as “moral hazard,” set the stage for a financial crisis.

The argument that moral hazard causes financial crises has prompted many proposals to curb it, ranging from a mandatory imposition of losses on foreign lenders and investors to the elimination of the IMF. However, these proposals ignore the fact that foreign investors and lenders have in fact sustained large costs in recent crises. According to the Institute of International Finance (IIF), in the East Asian and Russian financial crises foreign equity investors lost an estimated \$240 billion and foreign lenders (banks and other creditors) lost about \$110 billion (see Box 6, page 34). The mandatory imposition of additional costs is not a necessary ingredient of a crisis resolution strategy. It may, in fact, make crises more likely if investors and lenders react strongly to changes in economic conditions that could lead to bail-ins. Moreover, to the extent that countries regulate short-term capital inflows through Chilean-style taxes and foreign lenders try to withdraw their money early, bail-ins will automatically occur through the tax system.

From a longer-term perspective, efforts to impose costs on foreign private-sector lenders during a crisis would most likely discourage

foreign investors from future lending. In particular, we are concerned that proposals that create a higher probability, or in some cases a certainty, of significant losses would lower the supply and increase the cost of capital for emerging markets. In our view, most so-called bail-in proposals are misguided. It makes little sense to encourage countries, on the one hand, to put in place policies that are meant to attract foreign private capital and, on the other hand, to repel that capital through imposing additional costs on it. Any new policy should recognize the constructive role played by foreign lenders in normal times and the destructive effects that would follow from mandating losses.

A Specific Proposal for International Bond Contracts

One proposal for bailing in foreign private-sector lenders has drawn considerable attention. It would require so-called collective action clauses in bond contracts to provide a means of creditor coordination in the event that a borrower appears unable to pay its debt. This proposal is prominent among reforms recommended by the Council on Foreign Relations.⁴⁹ It calls for a clause in international bond contracts that would spell out procedures for collective representation of creditors, such as bondholder councils, qualified majority voting, or sharing clauses that limit the rights of dissident creditors to disrupt workout agreements. Part of the motivation for requiring that bonds have a collective action clause is to make it clear to lenders that they might not always be repaid, thus reducing moral hazard. Collective action clauses would also speed up debt rescheduling, which could help speed economic recovery. The requirement for collective action clauses, which are currently a feature of British-style bonds, would have to be imposed by law in the United States. Bonds issued

49. Report of an Independent Task Force Sponsored by the Council on Foreign Relations, *Safeguarding Prosperity in a Global Financial System* (Washington, DC: 1999).

BOX 6: EXAMINING THE EVIDENCE OF MORAL HAZARD

In principle, moral hazard is present whenever a guarantee of insurance against loss is made. Thus, if lenders and borrowers come to view IMF stabilization loans as insurance against loss, they will tend to engage in more credit activity than warranted by actual conditions. However, CED has been unable to find convincing evidence that moral hazard based in the international financial system has played a role in encouraging too much lending prior to any of the recent financial crises with the exception of Russia, which should be viewed as a unique case.⁵⁰ The little research that has been conducted on this topic finds no evidence that moral hazard induced by the resolution of the Mexican crisis had any effect on risk taking in emerging markets in general.⁵¹ Even the IMF has concluded that moral hazard based in crisis resolution programs was not much of a factor in the recent crises in Asia:

“International equity investors and holders of long-term debt instruments also do not seem to be substantially motivated by the prospect of international financial rescue operations. In fact, with stock markets and exchange rates plummeting, between mid-1997 and early 1998 the value of foreign portfolio investments in some Asian markets fell by half to two-thirds. There was never any reasonable basis for expecting that investors in equities would be shielded from such losses by government bailouts or international assistance. Similarly, bond investors clearly do not expect to be compensated for the immediate consequences of a crisis.”⁵²

News reports and other data show that foreign creditors were not sheltered from losses in the recent crises. Even foreign banks, which have been viewed by some as immune from financial loss because they typically provide funds in the form of very short-term interbank loans, were forced to book substantial losses and penalized by market traders who sold down the value of their stocks. Because they were heavily committed to Asian borrowers, Japanese banks are reported to have booked losses of about \$10 billion in 1997. In the United States, a sampling of data by CED on changes in stock prices for major

banks indicates that banks that were most heavily exposed in emerging markets suffered substantial declines in the value of their stock compared to banks that were much less exposed. Between June 1997 and August 1998, U.S. banks had to set aside hundreds of millions of dollars in provisions for bad loans.⁵³

Estimates by the IIF show that foreign interests have already been bailed in. Losses by equity investors in the East Asian and Russian crises may have amounted to about \$240 billion. Losses by international banks are estimated to have been \$60 billion; losses by other private creditors, including bondholders, are estimated at \$50 billion.⁵⁴ These amounts are far from trivial, even if they are smaller than domestic losses of income. Thus, recent experience should, at least for some time, curb any incentive to engage in risky lending. Indeed, the problem may turn from one of curbing excess lending to one of encouraging sufficient lending.

The lack of evidence and the existence of large private-sector losses do not, however, prove the absence of moral hazard. Aside from crisis lending by the IMF, other sources of moral hazard may exist. For example, earlier in this chapter we identified a fixed exchange rate policy as a potential source of moral hazard, because it purports to guarantee a set value for the domestic currency. Strong evidence exists that the combination of fixed exchange rates and high domestic interest rates induced excessive capital flows to some Asian countries through what is known as the carry trade.⁵⁵ To some extent recent experience should dampen investors' beliefs in the fixity of exchange rates. Adopting CED's recommendation for flexible rates would go even further toward resolving this problem. Perhaps more important, other actions by governments of crisis countries may have created other sources of moral hazard. For example, when Korea guaranteed the liabilities of its banks and major corporations, it shifted the costs from private lenders and borrowers to the government, thus potentially encouraging more future private lending than may be warranted. As discussed in Chapter 3 and elsewhere in this report, better domestic policies are needed to prevent future crises.

in the United States usually require unanimous consent to be rescheduled, which makes such action very difficult.

In general, bonds issued by private-sector entities pose no new policy issues. In principle, defaults on corporate bonds can be resolved by either voluntary arrangements, such as debt-for-equity swaps, or a domestic bankruptcy procedure that has clear rules and is administered fairly by an independent judiciary. However, bonds issued by the public sector—sovereign issues—do present unique problems.

In the case of sovereign bonds, neither debt-for-equity swaps nor bankruptcy proceedings are options; governments do not issue equity, do not provide real collateral, and are only “liquidated or restructured” through a political, rather than financial, process. For that reason, credit problems have been worked out under special arrangements through creditor clubs or other means. The collective action problem—namely that creditors and other owners of financial assets, including domestic residents, have an incentive to export their capital before others do, or to take advantage of others’ willingness to accept workouts—is particularly acute with regard to sovereign bonds.

CED believes that the United States and

50. IMF loans to Russia were clearly based on political considerations and rightly viewed by many as an extension of U.S. foreign policy. Ironically, the one case where investors may have been induced to make loans because of moral hazard is also the one case where investors took substantial losses because the country defaulted on its loans without being rescued by the IMF.

51. Xiaoming Alan Zhang, “Testing for “Moral Hazard” in Emerging Markets Lending,” IIF Research Papers No. 99-1 (Institute for International Finance, August 1999). See also, Remarks of William R. Cline, “Private Sector Participation in the Prevention and Resolution of Financial Crises,” prepared for the IMF Conference on Key Issues in Reform of the International Monetary and Financial System, Washington, DC, May 28-29, 1999.

52. IMF, *World Economic Outlook*, May 1998. For a similar analysis, see Richard Cooper, Speech at the Committee for Economic Development Forum on Designing a New International Financial Architecture, New York City, May 1999.

53. “Russia’s Moves Shake Growing Involvement of U.S.,” *American Banker*, August 18, 1998.

54. Institute for International Finance, *Report of the Working Group on Financial Crises in Emerging Markets* (IIF, January 1999) p. 61.

55. IMF, *International Capital Markets*, September 1998, p. 44.

other countries where international bonds are issued should leave the decision of whether to use collective action clauses in international bond contracts to market participants, rather than mandating their inclusion. There are now, and should continue to be, ample opportunities for market participants to choose the form of bond contract they prefer on a voluntary basis. Mandating an easier path for collective action may make rescheduling easier in the short term, but is likely to be damaging to emerging markets’ access to funds over the long term. We recognize that bond rescheduling may be necessary from time to time and we expect that some lenders and borrowers will choose contracts that would lower the cost of such rescheduling through collective action arrangements. The choice of whether to accept those arrangements should be subject to negotiation, not mandated by public officials.

We believe that mandating such clauses would erode the discipline of repayment and make it too easy for a government to choose rescheduling.⁵⁶ Rescheduling should not be made *too* easy, lest debtors lose the discipline needed to maintain regular debt payments or, alternatively, creditors reduce the supply of credit for the same reason. Bond payments have neither been a significant factor in the recent crises, nor would relief from such payments significantly assist a country in financial trouble. The annual amortized value of Eurobonds due from emerging market countries is estimated to be \$30-40 billion. By contrast, those countries’ stock of short-term external debt is estimated to be about \$500 billion.⁵⁷ Although

56. British-style bond issues allow 65 percent to 85 percent of holders to vote to restructure bond contracts under various conditions. American-style bond issues typically require at least 95 percent of bondholders to agree to renegotiate the debt. American-style bonds also give investors greater ability to sue issuers who do not pay. See Mitchell Martin, “Wall Street Sees Red at U.S. Plan for Bondholders to Accept More Risk,” *International Herald Tribune*, April 26, 1999.

57. Remarks of William R. Cline, “Private Sector Participation in the Prevention and Resolution of Financial Crises,” prepared for the IMF Conference on Key Issues in Reform of the International Monetary and Financial System, Washington, DC, May 28-29, 1999.

the stock of short-term debt is unlikely to be demanded for repayment all at once, since most of it is rolled over upon maturity, it represents a large overhang of liabilities that could be demanded for repayment.

We are pleased to see that our position is currently reflected in the views of Treasury Secretary Summers, who has coupled his support for market-based bond contracts with a warning:

“We have become convinced that it is not appropriate for the official sector to mandate the terms of debt contracts between countries and their creditors. But lenders and borrowers alike must recognize that if they choose contractual arrangements that are costly and inefficient in the event of failures, the official sector will not be prepared to shoulder the consequences.”⁵⁸

58. Lawrence Summers, “The Right Kind of IMF for a Stable Global Financial System” Remarks at the London Business School, London, England, December 14, 1999

CHAPTER 5

IMPROVING THE IMF



The role of the IMF cannot be viewed in isolation from other aspects of the international financial system. How the IMF fits into that system depends critically on how the other parts of the system operate. In some ways the IMF is a residual institution in the market-based international financial system—one whose role and responsibilities begin where the others' end. If all parts of the system worked ideally, there might be no need for the IMF.

In earlier chapters we emphasized the need for each nation to take responsibility for improving its own economic policies and proposed specific steps they should take. As governments carry out those reforms the demands on the IMF should diminish somewhat. But we know that financial markets will not operate perfectly even with reform. Thus, we conclude that a strong International Monetary Fund is indispensable to the continued stability and vitality of the international financial system. When a country is faced with a financial panic that it is unable to resolve on its own, the IMF should be prepared and financially able to act.

As this project neared completion, Secretary of the Treasury Lawrence Summers outlined for the first time the Administration's views on the future role of the IMF.⁵⁹ Those views are very similar to the recommendations presented here. Secretary Summers focuses on six areas:

- A greater focus on promoting the flow of

information from governments to markets and investors.

- Attention to financial vulnerability as well as macro-economic fundamentals.
- A more selective financing role, focused on emergency situations.
- Greater emphasis on catalyzing market-based solutions.
- A more limited role in the poorest countries, focused on growth and poverty reduction.
- Modernization of the IMF as an institution.

The analysis below spells out CED's views on these critical areas of reform.

THE TRADITIONAL ROLE OF THE IMF: CONSULTATION AND LIMITED FINANCIAL SUPPORT

The Bretton Woods Agreement, which created the IMF and World Bank, envisioned the role of the IMF as limited primarily to financing current account deficits in a system based on fixed (but ultimately adjustable) exchange rates.⁶⁰ That is the role the IMF played until the larger industrialized countries abandoned fixed exchange rates in 1973. Since 1973, the IMF has focused primarily on developing coun-

59. *ibid*

60. For an informative discussion of the history and current issues facing the World Bank and IMF, see Anne O. Krueger, "Whither the World Bank and the IMF?" *Journal of Economic Literature*, Vol. XXXVI, (December 1998) pp. 1983-2020.

tries, many of which have retained some form of fixed exchange regime, and especially on those countries that have reached an advanced stage of global economic integration. IMF lending usually carries some conditionality—that is, the borrowing country typically has to agree to some performance conditions before a loan is approved. In addition, the IMF was, and remains, a leading source of research and analysis on international financial problems.

Periodically, member countries have agreed to add resources to the IMF. In 1960, the IMF's Articles of Agreement were amended by the General Arrangements to Borrow, which added resources to the IMF that could be used in the case of sudden capital outflows. In 1987, in the aftermath of the debt crisis of the 1980s, the Enhanced Structural Adjustment Facility (ESAF) was created. The ESAF was intended to address structural problems by providing financial support to the IMF's poorest members at longer terms and lower rates than that available through normal channels.⁶¹ At the start of 1999 the IMF implemented a quota increase and "New Arrangements to Borrow," which added about \$90 billion to the Fund's ability to meet short-term liquidity crises. It has also initiated a new credit line, the Contingent Credit Line (CCL), which is intended to support members with fundamentally sound economies that are concerned about their vulnerability to contagion. Such support is expected to help prevent contagion and ensuing financial crises.

In general, IMF programs are characterized by a number of common features. Financial support typically is given as part of an overall program that includes macroeconomic policy adjustments on the part of the borrowing country. Countries that have balance of payments problems almost invariably expand consumption or investment too rapidly, as evidenced by an excess of imports. Thus, IMF programs gen-

erally are designed to suppress demand by imposing fiscal and monetary restraint, or to switch demand from foreign to domestic suppliers through devaluation. Recent experience has caused some IMF officials to rethink how to respond to situations where the crisis may be due to financial speculation rather than an overheated economy, or where an economy has already fallen into recession. In those cases, restrictive policies may be inappropriate.

In part, because of the negotiations necessary to reach agreement and its system of internal review and voting, IMF programs often take time to develop. In addition, loans are generally limited to a fixed percent of the country's quota, with limits on amounts that can be borrowed both annually (100 percent of quota) and over several years (300 percent of quota). One of the significant features of recent financial crises is the increase in the scale of financial commitments. The rescue package for Mexico put together by the IMF and the United States in 1995 equaled about \$50 billion. IMF-led financing for Asia, Russia, and Brazil committed about \$190 billion, although much of that amount did not need to be disbursed. Significantly, these financing packages included commitments not only from the IMF, but also from individual countries and other international financial institutions. In addition, IMF commitments went far beyond the normal limits of 100 percent of a country's quota, into the range of 500-700 percent for most countries and 1900 percent in the case of South Korea.⁶²

CED believes that business and political leaders in the United States should work to ensure adequate funding for the IMF and improvements in its policies and operations. The IMF should place more emphasis on crisis prevention through better policies and greater transparency and less on costly stabilization

61. In November 1999 the ESAF was renamed the Poverty Reduction and Growth Facility (PRGF) and its objectives were revised to link poverty reduction with debt forgiveness under the HIPC initiative.

62. "Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture," Report of an Independent Task Force Sponsored by the Council on Foreign Relations, p.16.

programs. It should maintain normal lending limits and a policy of “constructive ambiguity” with regard to specific cases to diminish concerns about moral hazard. The IMF should have adequate—though not abundant—resources to promote both crisis prevention and stabilization.

When stabilization lending beyond the normal capacity of the IMF is required, individual nations in crisis, in conjunction with the IMF acting as a “crisis manager,” will have to assess what steps will be necessary to secure financial stability. One implication of this policy is that in some cases countries will need to pursue debt rescheduling with their public and private creditors or be forced into default. Another is that we will have to rely on the expert judgment of officials at the IMF, who have been entrusted with oversight of the international financial system, with regard to the specific steps that should be taken. Our expectation is that those officials will act in the best interests of both the country in crisis and the international financial system.⁶³

IMPROVING IMF OPERATIONS

A major objective of efforts to reform the international financial architecture is to improve the operations of the IMF. Many reforms are already being adopted, including those to increase transparency, improve IMF data standards and surveillance, increase assistance to strengthen financial systems of member nations, and establish new sources of funding and new procedures for borrowing. The IMF is now taking a stronger surveillance role in its regular reviews of member countries’ practices, especially in the area of financial sector supervision. In addition, it is participating in and

publicly monitoring the work of the various institutions and forums in which standard setting and other reforms are being carried out. It is also a leading participant in the initiative to reduce the burden of debt on the heavily indebted poor countries.

Partly in recognition of the new demands being placed on the IMF and its role in the global financial system, the IMF Interim Committee has been given permanent status and its name changed to the “International Financial and Monetary Committee.” The IMF is also responding to the demand for greater transparency in its own operations. It has adopted a presumption in favor of release of information, both with respect to its own deliberations and the advice it offers to member countries. In response to other demands, the IMF is developing formal mechanisms for evaluating its own operations, programs, policies and procedures, including external review of its surveillance and research activities. It is also strengthening its Special Data Dissemination Standard and General Data Dissemination Standard, which provide guidance to countries’ reports on key economic variables.

The IMF is to be commended for reevaluating its own policies; however, it should go further and faster than it has to date in adapting to the new realities of the international financial system. We believe that the IMF must continue to improve its operating procedures by becoming more transparent and accountable with regard to its own decision making and providing better and more frequent information to the public. We recognize that the specific policies we are recommending for public disclosure of currently privileged information and for combating fraud and corruption will be difficult to carry out. However, as discussed below, we are confident that once they are implemented, these policies will prove their value and opposition to them will subside.

Requiring the Release of Information

Although the IMF has taken some important steps to encourage countries to release

63. The *Report of the International Financial Institution Advisory Commission*, presented to Congress in March, 2000 as this project was being completed, recommended that the IMF’s stabilization lending be subject to more explicit rules, including the prequalification of borrowing countries. In our view this would substantially reduce the flexibility of the IMF and thereby its effectiveness in dealing with financial crises.

publicly information developed in the course of Article IV consultations, we recommend that the IMF go beyond *encouraging* the release of that information and *require* that Article IV consultations be released publicly within 60 days after the consultations take place. This policy change should be phased in over a reasonable period, perhaps one to two years. Developing countries should understand that the release of such information is part of the broad effort they need to make to keep markets informed of their economic conditions. The more information that is regularly released, the more comfortable private investors will become with investing in developing countries and the more comfortable those countries will be with the public release of information that may at times be unfavorable. Although some have argued that countries will become less candid in discussions with the IMF about their problems, in our view objections to public release will most likely disappear when the benefits, in the form of greater access to lower priced capital, take effect. Much like the standard setting efforts described in Chapter III, countries that support the regular release of Article IV information should find that markets will help them to improve their policies and performance and ultimately reward them with lower-cost capital.

Combating Fraud and Corruption

The IMF should take greater responsibility for identifying, monitoring, and investigating how IMF funds are spent and for ensuring that such funds are not siphoned off in fraud and corruption. It must take more seriously its responsibility to ensure that funds borrowed by member countries go to their intended purposes rather than to Swiss bank accounts. Recent news accounts, especially with regard to loans to Russia, raise troubling questions about the IMF's policies and procedures, which seem to tolerate corruption and misuse of funds. Fund officials should understand that public support in the United States and other developed countries will not be sustained unless clear and visible public efforts are made to stop

corruption and to show that funds are being used for intended purposes. The IMF should view its role in this regard in much the same manner as it views its role with regard to policy conditionality. The IMF should step up pressure on countries that condone fraud and corruption and, when it is aware of such abuses, should expose them. It should also enhance its ability to monitor loans and other expenditures. Because money is fungible, that may require greater monitoring of central bank activities and government finances.

Where the occurrence of fraud and corruption in a nation that is receiving financial support from the IMF impedes the sound functioning of political, legal, and judicial systems, we recommend that the IMF cease its support. Doing so will conserve the IMF's resources and earn it continuing credibility for its present and future recommendations and requirements.

CRISIS PREVENTION

The attention given to the role of the IMF during financial crises should not obscure its role as both lender and advisor to countries that are experiencing economic difficulties, even if not in crisis. The prevention of crises is one of the IMF's most important and underappreciated tasks. The IMF will continue to play a vital role as an advisor and source of funding to support macro-economic adjustments, especially for smaller low-income economies. Most IMF loans are made in non-crisis situations. **In its lending and advice, the IMF should emphasize sound macroeconomic policies and improvement of banking and financial systems.** Through both normal consultation and lending, the IMF in conjunction with the World Bank, which promotes long-term structural change, can play an important role in inducing countries to adopt policies that will improve their ability to absorb setbacks, adjust to short-term perturbations, and assist their long-term development. Those policies increasingly should be designed to attract private-sec-

tor financing in the form of foreign direct investment, bonds, shorter-term trade credits, and even contingent credit for stabilization lending. In addition, safety-net policies should be part of a country's short- and long-run strategies, as discussed in Chapter 3.

Some observers have called for the creation of a powerful new organization, either an enhanced IMF or a new agency, that could insure investors against default or otherwise regulate credit markets.⁶⁴ Such regulation — insurance implies regulation — would have the effect of allocating capital to “good performers” and would substitute bureaucratic judgment for the judgment of the market. We believe that such an entity is unnecessary and, indeed, would have negative consequences over the long run by creating greater dependency of borrowers on such an authority. Developing countries need to take more, not less, responsibility for their policies. Moreover, at a practical level it would be impossible for an international bureaucracy to have the authority it would need to make such a system work. Private market incentives can operate effectively without recourse to such regulatory schemes.

CRISIS RESOLUTION

The history of financial crises demonstrates the need for a monetary institution that can backstop the market by adding liquidity to the system when necessary to forestall or halt a panicked conversion of illiquid assets into money.⁶⁵ However, such a lender can create moral hazard if it always steps in to ensure that creditors are paid. These conflicting demands

have led to considerable policy debate and difference of opinion on the ultimate desirability of such an institution at the international level. In our view, the international financial system needs to have a financial backstop, but there should be some uncertainty among market participants about whether that backstop will in fact lend during any particular crisis.⁶⁶

At the national level, the role of lender of last resort is generally filled by the domestic central bank, although historically it has also been played by foreign central banks and by private-sector lenders. At the international level, even though the IMF lacks the capacity to act as a true lender of last resort, it has played an important role in lending to help establish financial stability.⁶⁷ Stanley Fischer, First Deputy Managing Director of the IMF, notes that, although the IMF is not a true lender of last resort because it cannot create money, in many, if not most, situations it will either have sufficient funds to lend or be able to assemble a consortium of lenders with sufficient funds.⁶⁸ Fischer also argues that the IMF can play a role associated with the lender of last resort, which is that of crisis manager—“the institution that takes upon itself the responsibility for dealing with a crisis or potential crisis, whether or not it itself lends for that purpose.”⁶⁹

These IMF actions — lending and coordinating international assistance to countries in financial crisis — are essential for both stabilizing such economies and avoiding the spread of financial panic to other countries. Once a psychology of panic sets in, as it clearly did in the

64. See George Soros, *The Crisis of Global Capitalism*, (New York: Public Affairs Press, 1998); and Henry Kaufman, “Preventing the Next Global Financial Crisis,” *The Washington Post*, January 28, 1998, p. A17. Soros’ proposal is for a public corporation to insure investors against debt defaults; Kaufman’s proposal would create an international regulator for international financial markets and institutions. Similar proposals have been made by others.

65. In particular, see Charles P. Kindleberger, “Manias, Panics, and Crashes: A History of Financial Crises,” (New York: John Wiley & Sons, 1996).

66. *ibid*

67. The IMF cannot fully play the role of lender of last resort for a number of reasons: it cannot create money as a central bank can, the amount of resources available for loan to any one country is limited; funds are disbursed in tranches (or portions) over time; and its decision-making processes are too slow.

68. Stanley Fischer, “On the Need for an International Lender of Last Resort,” paper prepared for delivery to the American Economics Association and the American Finance Association. New York, January 3, 1999. Available at <http://www.imf.org/external/np/speeches/1999/010399.htm>

69. *ibid*.

Asian crisis, markets become unstable. Market instability raises risk and makes people highly uncertain about the future and very reluctant to take economic actions. Confidence needs to be restored before the crisis moves out of control and spreads to other countries. When a government cannot quell the panic by itself, restoring confidence should be the IMF's paramount mission. The IMF should not be reluctant to lend when necessary to halt a financial panic, but it should maintain the flexibility to decide on a case-by-case basis. The requirement that the IMF distinguish between cases that merit lending and those that do not is essential to a policy of "constructive ambiguity." Establishing some doubt for lenders that the IMF will rescue them will reduce moral hazard and improve the functioning of markets.

We are concerned that preoccupation with the possibility that IMF lending may result in protection for certain creditors may make it reluctant to act. In general this dilemma should be resolved strongly in favor of stopping an immediate crisis. The private sector generally will suffer economic losses as firms that make overly risky loans and investments are forced to write-down their value, and equity markets discount the value of those firms. Similarly, banks that are forced to extend the maturity of short-term loans do not escape additional costs.

Private-sector lenders and investors should, and do, bear the risks of their decisions. Risk and uncertainty are already major factors in the calculations of international lenders and investors. Because the IMF has limited command over funds that can be committed and occasional defaults will occur (as in Russia and more recently in Ecuador) those factors are far from diminished. **Given recent experiences and the current climate of opinion, private-sector lenders should foster the understanding that businesses cannot and should not rely on local government or IMF bailouts to insure against losses on investments or loans.** Prudent business investors recognize the limits of interna-

tional rescue packages relative to the size of potential financial claims. They should also note the current bias of international officials toward the imposition of additional private sector burden-sharing in the wake of recent experience in emerging market crises.

While we understand that some private-sector lenders and investors will and should take losses in financial crises, we believe that the IMF should act as a neutral "crisis manager" when the need arises—neither bailing in nor bailing out foreign lenders. Its function should be to help a country to stabilize its economy and achieve a sustainable level of foreign currency obligations. In some cases that may result in financial losses for foreign private-sector investors and lenders, but such losses should be a consequence of fundamental policy decisions and negotiated debt restructuring, not the deliberate objective of IMF stabilization programs.

The IMF should not view the determination of how countries will resolve their debts to foreign creditors as part of its mission. The decision on how to resolve potential defaults should be made by a nation and its creditors. By imposing its own view of appropriate burden sharing, the IMF would be unnecessarily inserting itself into decisions that should be determined by market participants. In general, so-called "private-sector bail-ins" would not serve the interests of developing nations. Imposing costs on private investors, beyond those they already bear, would lower the supply and increase the cost of capital for those countries. Rather than mandate how costs will be distributed, IMF policy should support a country's right to determine for itself whether it wants to accept those longer-term costs in exchange for short-term relief from private debt payments. Although IMF managers will find it difficult to maintain the appropriate balance among competing policy goals, they should focus on the restoration of confidence and the sustainability of economic growth within a client country, not the size or form of financial losses incurred by foreign private-sector investors and lenders.

CONCLUSION

Most of the problems that have afflicted emerging market countries have been home grown, including moral hazards in the form of unrealistic guarantees extended through pegged exchange rates and government-guided financial systems. Developing countries need to bring their economic practices and domestic institutions up to world-class standards and rely more on the power of markets to facilitate economic growth and development. To assist this process, they should improve the transparency, quality, and frequency of the public- and private-sector information provided to those markets.

Our emphasis in this report has been on the benefits of market-driven improvements to the international financial system. Our recommendations are founded on the belief that markets will reward countries with institutions and policies that engender confidence, attract private capital, and allocate capital efficiently. With regard to the controversial issue of so-called private-sector bail-ins, we support private-sector arrangements based on market-determined outcomes rather than government-mandated solutions. We believe negotiations between lenders and borrowers should deter-

mine the substance of bond contracts, and we support market-based negotiations between debtors and creditors when necessary to resolve potential defaults.

We recognize both the need for developing country governments to help themselves and the indispensable role of the IMF in preventing financial crises where possible and stabilizing afflicted economies if prevention fails. We have confidence in the expertise and discretion of IMF officials to manage crises, and we do not wish to see them hamstrung by too many rules. We want the IMF to be adequately, although not abundantly, funded.

The international financial system is fundamentally sound, although more susceptible to financial crisis than it need be. We urge business leaders and officials in governments and the IMF to carry out the comprehensive set of incremental reforms recommended in this report. These reforms must be viewed as a package; many individual recommendations will be most effective only if others are implemented. We firmly believe that adoption of this package of recommendations would significantly enhance the stability of the international financial system and reduce its susceptibility to crisis.

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